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Tax Rulings and State Aid

LLM Paper
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**Personal Foreword:**

Before turning to the introduction of this LLM paper, I want to provide an explanation of my motivation in choosing the topic of ‘Tax Rulings and State Aid.’ I am a native of Cork, the Republic of Ireland’s second largest city. As well as being the home of Pfizer’s Viagra, Cork is also home to Apple’s European headquarters since 1980. Today the company employs 6,000 people at its Cork site, including many of my own friends and family. It is a great source of pride for the people of Cork. From an Irish perspective, the arrival of companies such as Apple, Intel and IBM in the 1980s marks a period of great economic and social change in Ireland. With mass emigration and crippling unemployment, the shadow of the troubles in Northern Ireland and the overarching influence of the Catholic Church on Irish life; the jobs and economic prosperity that these companies brought with them allowed Ireland to shed the shackles that held it back for so long. Ireland’s longstanding neutrality, its right to restrict abortion and our 12.5% corporate tax rate – have long been considered the holy trinity of Ireland’s sovereignty and hard won independence from Britain. The second Lisbon Treaty referendum was put to the people of Ireland, muintir na hÉireann, on October 2nd 2009, with assurances from the European Union in the form of the Protocol on the concerns of the Irish people on the Treaty of Lisbon: that changes to the Treaty would not alter Ireland’s sovereignty in these matters. Article 2 of that Protocol states "Nothing in the Treaty of Lisbon makes any change of any kind, for any Member State, to the extent or operation of the competence of the European Union in relation to taxation."

The Commission decision in Apple angered many in Ireland. On one hand, it was seen as a continued assault on Ireland’s corporate tax regime by Brussels. The memory of Nicolas Sarkozy’s remarks that Ireland should only be allowed access to the EU/IMF bailout funds in 2011 in exchange for raising its corporate tax rate was fresh in the mind. On the other hand, it is seen as yet another example of Ireland Inc.’s close relationship with business, the root of the banking crisis and the subsequent decision to provide a blanket guarantee to Irish financial institutions in 2008. However, despite the promise of €13 billion in back-taxes, funds which could be used to restore public services following a decade of harsh austerity; a majority of Irish people support the Government’s decision to appeal the decision.

This spurred my interest in tax rulings in general and when the time came to chose a topic for my LLM paper, it was a natural choice. As the saying goes, there is no smoke without fire, so I was eager to explore whether the Commission’s findings had truth them. I was also very motivated to explore the relationship between EU law and corporate taxation given it’s importance to the Irish economic model. However, I was also curious as to whether the decisions in relation to the other Member States beared any resemblance to that granted by Ireland to Apple.

In addition, I would like to take the opportunity to extend a sincere thank you to all those have contributed to my completing this paper. My parents for making all this possible, Niels for his continued support and cups of coffee and my friends for taking my mind off it when it was necessary. It would not have been possible without all of you.
General Introduction:

“This isn't about interfering with national tax laws. There's nothing to stop EU governments from deciding to apply a low tax rate to everyone. They just have to make sure that when they apply their tax laws, they don't give certain companies special treatment.”

- Margrethe Vestager -

The words of European Commissioner for Competition, Margrethe Vestager addressing a delegation in her native Denmark at the Copenhagen Business School one week after the Commission presented its landmark final decision in relation to State aid granted to Apple by Ireland. That decision and those issued in relation to tax rulings granted by Luxembourg, Belgium and the Netherlands to multinational enterprises marked the beginning of a new era in the fight against aggressive tax planning and harmful tax competition within the European Union.

In this paper I seek to examine the compatibility of tax rulings granted by Member States to multinational enterprises with EU State aid rules. I intend to explore this question within the context of the Commission investigations in relation to corporate tax arrangements provided to Apple in Ireland, Fiat Trade and Finance in Luxembourg and the Excess Profit Exemption Scheme in Belgium. The issue of tax rulings and State aid goes the very heart of the inherent tension that is present in the European Union, namely, the sovereignty of the Member States and the powers they have transferred to Union. Therefore, I will frame my analysis within the context of the political and economic environment. This is key as the decisions are more than a finding of illegal State aid, they are a statement to Europeans and to those companies operating in the EU alike, that EU State aid rules transcends national divergences in taxation and will not tolerate national measures that facilitate the erosion of Member State tax bases. They also signify the greater role the EU intends to play on a global stage in the fight against tax evasion. Therefore, I also intend to explore the relationship between EU state aid rules and principles of international tax law such as those developed by the Organisation for Economic Cooperation and Development (OECD) and the interplay of that relationship in respect of national tax rules. This will not form a separate analysis but will be explored continuously throughout this paper. In saying that, as part of my examination I will specifically address important the essential topics of transfer pricing and the nature of tax rulings in general. In the same speech, Margrethe Vestager said that the issue of fair taxation “belongs at the top of our agenda, not only in Europe but throughout the world.” Therefore, I seek to examine the impact of those decisions and other recent measures adopted by the Commission and Council to combat aggressive tax planning on tax rulings going forward in light of European and International developments, specifically the OECD Base Erosion and Profit Shifting (BEPS) Action Plan.

Let me set some parameters to this paper. The issue of recovery of State aid while an important and interesting issue with regard to tax rulings; will not form a specific topic examined in our discussion of tax rulings and State aid. This represents an appropriate point to turn to the first chapter of this LLM paper.
1. Chapter One: Preliminary Issues

1.1. The application of EU State aid rules to taxation:

In this section I will briefly outline the application of European Union [hereinafter: EU] State Aid rules to the area of taxation. Article 107(1) provides that “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.” It follows that Article 107 contains four criteria that must be satisfied in order for a measure to come within the remit of State Aid rules. The culmulative criteria are:¹

1. The measure must confer an advantage.
2. This advantage must only be conferred upon certain undertakings or production of certain goods – it must be selective.
3. This advantage must be granted through State resources.
4. The measure must distort or threaten to distort to competition in the internal market and affect trade between the Member States.

With regard to the applicability of State Aid rules to taxation, the prohibition contained in Article 107(1) covers “any aid granted...in any form whatsoever” and the Court of Justice of the European Union [hereinafter: CJEU] has given a broad interpretation to what this encompasses in relation to taxation. The Court confirmed in the aforementioned judgment, despite the fact that taxation is an exclusive competence of the Member States; that even in the area of taxation, the “alleged fiscal nature...measure in issue cannot suffice to shield it from the application of article [107].”² However, national tax measures only come within the scope of State aid when the aid consists “of derogations within the same national tax system, which are not justified by the nature or scheme of the same system.”³ The guidelines for dealing State Aid in relation to fiscal measures are not a concrete formula and have been developed through case law of the CJEU. In the late 1990s, there was a push to combat harmful tax competition within the European Union and this culminated in the Commission Notice on the application of the State aid rules to measures relating to direct business taxation, 1998. This was borne out of a commitment by the Commission to the strict application of State aid rules in relation to taxation in the Code of Conduct on Business Taxes 1998.

Furthermore, general tax measures which can be defined “as measures which are open to all economic agents operating within a Member State,”⁴ will not constitute state aid so long as

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⁴ Commission Notice on the application of the State aid rules to measures relating to direct business taxation,
they are “effectively open to all firms on an equal access basis, and they may not de facto be reduced in scope through, for example, discretionary power of the State to grant them or through other factors which restrict their practical effect.”5 This left no doubt that Member States as economic actors and as sovereign fiscal states are indeed free to set tax policy but they are required to do so within the limits of Union Law. However, the application of State Aid rules to tax matters is problematic as some substantive requirements are difficult to apply in practice for matters relating to taxation. This is especially true for the selectivity criterion, as we will see at a later stage in this paper.

1.2. The economic and political context:

The Commission investigations into the tax arrangements of some multinational enterprises in Luxembourg, Ireland, Belgium and the Netherlands may have come as a surprise to many but in reality this is not a new phenomena. As already stated since, the late 1990’s there has been recognition that the lack of harmonisation in the area of direct taxation has facilitated the aggressive tax planning by MNEs. The Commission’s 1997 Communication “Towards Tax Coordination in the European Union – A Package to Tackle Harmful Tax Competition” highlighted the need for action to “reduce distortions to the Single Market; to prevent significant losses of tax revenue; and to reverse the trend of an increasing tax burden on labour as compared to more mobile tax bases.”6 The Single Market and the subsequent creation of the Economic and Monetary Union (EMU) in 1993 increased the importance of taxation as a competitive factor. The Communication notes that “as regulatory barriers in the Single Market are dismantled, taxation is increasingly identifiable as a key factor influencing economic decisions”7 and accurately predicts that harmful tax competition will “become an increasing source of conflict among Member States unless greater co-ordination can be achieved within the EU.”8 This lead to the adoption of the Code of Conduct on Business Taxation9 in which the Member States commit themselves to refraining from introducing new tax measures that are harmful10 and to re-examine existing laws and established practices with a view to eliminating harmful measures.11 Furthermore, the Member States commit themselves to the strict application of State aid rules in light of the Commitment by the Commission to introduce guidelines on the notion of State aid with regard to direct business taxation.12 Indeed, the Commission published its Notice in 1998.13

5 Ibid.
6 Commission Communication to the Council of 21 October 1997, Towards Tax Coordination in the European Union A Package to Tackle Harmful Tax Competition, COM(97) 495 Final, paragraph 2; [hereinafter Commission Communication].
7 Ibid. paragraph 7.
8 Ibid. paragraph 11.
10 Ibid. Recital C.
11 Ibid. Recital D.
12 Ibid. Recital J.
The Staggering growth of multinationals epitomizes the globalization process that has been triggered by technological advances and presents both an opportunity and a challenge for the European Union. Both EU and non-EU MNEs employ a large number of people in the Union. For example, US companies operating in the EU accounted for about 13% of EU GDP (sales of $2.1 trillion), employing 3.8 million people. It is estimated there are 6000 multinationals with a presence in the EU, with 2000 of those headquartered in the EU. Indeed, 99% of the 7.5 million businesses in the EU are small to medium sized businesses (SMEs). Indeed, the growth of MNEs presents “increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context.” However, MNEs have utilised the EU’s fragmented and diverse corporate tax systems to shift profits to lower tax jurisdictions within the EU. Indeed, tax rates vary from 10% in Bulgaria, 12.5% in Ireland to a high of 35% in Malta. The lack of harmonisation in direct taxation has facilitated the shifting of profits from one EU jurisdiction to another.

The issue of profit shifting gained more attention in recent years in the context of the global financial crisis. Governments across the EU were faced with rising unemployment and widening budget deficits as well as ballooning sovereign debt. With Member States obliged to reduce budgetary deficits below the 3% of GDP threshold and structural deficits to below 60% of Debt-to-GDP ratio under the EU’s Fiscal Compact, the importance of maintaining their tax bases was more relevant than ever. Moreover, the issue gained global attention following a meeting of G20 leaders in Cancun, Mexico in June 2012. The leaders explicitly made reference “the need to prevent base erosion and profit shifting” in their final declaration. In addition, following a meeting of G20 Finance Leaders on 5th-6th November 2012, British Chancellor of the Exchequer, George Osborne and German Finance Minister Wolfgang “called on their G20 colleagues to back the Organisation for Economic Cooperation and Development’s (OECD) work on identifying possible gaps in the standards as a first step in promoting a better way of dealing with profit shifting and the erosion of the corporate tax base at the global level.” Similar concerns were voiced by US President

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Barack Obama in his Framework for Business Tax Reform

Framing the decisions within the economic and political context is an important step in understanding the Commission investigations as it is against this backdrop that the investigations were initiated. Indeed, the need to tackle base erosion and profit shifting is a matter of global importance and any development at EU level cannot be viewed in insolation.

1.3. The Tax Rulings in Focus:

1.3.1. **FFT:**
The Commission investigation case in **FFT** concerns a tax ruling on transfer pricing granted by the Luxembourg Tax authorities in 2012. The ruling endorses a method for the allocation of profits to FFT. Fiat Trade & Finance (FFT) is a part of the Fiat Group. FFT, based in Luxembourg provides treasury services and financing to the Fiat group companies and manages cash pool structures for the Fiat group companies based in the UK, Denmark, Belgium, the Netherlands, Switzerland, Austria, Germany and Spain. The Commission decision reveals that FFT engages in two categories of cross-border transactions. The first category comprise of intra-sector loans to other Fiat Group treasury companies while the second comprises of intra-company transactions between treasury companies and other Fiat Group companies. FFT’s tax advisor deemed the transactional net margin method (TNMM) as being the most appropriate to determine FFT’s taxable base. The tax advisor calculated the remuneration due to FFT based on the following method. First, an estimation of FFT’s “capital at risk”; secondly, the identification of FFT’s capital used to perform the functions and to support the financial investments; thirdly, an estimate of the expected remuneration of FFT’s “capital at risk” by using the Capital Asset Pricing Model (CAPM) and identification of the return to reward the capital used to perform the functions; and finally, calculate the overall profitability to be left to FFT to remunerate the risks borne and the functions performed by combining the results of steps one to three. The Luxembourg tax administration accepted this method as resulting in an arm’s length remuneration of FFT’s taxable profit.

1.3.2. **Apple:**
The Commission investigation in the Apple case focuses on an individual tax rulings in 1991 and 2007 purportedly granted to the Irish branches of two Apple associated companies – Apple Sales International [hereinafter ASI] and Apple Operations Europe [hereinafter AOE] by Revenue in Ireland. These tax rulings endorse methods for the allocation of profits to the Irish branches. At this point it is useful to set out Apple’s corporate structure in the Republic of Ireland as described in the final decision. ASI is fully owned by AOE which in turn is

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22 Ibid. Recitals 52-70.
owned by Apple Operations International (AOI) which is a fully owned subsidiary of Apple Inc. Both ASI and AOE were incorporated in Ireland but were not resident in Ireland for tax purposes. The so-called ‘Double Irish’ was a product of Irish tax legislation at the time. Section 23A of the Taxes Consolidation Act 1997 [hereinafter TCA 97] provided two exceptions to the general rules on corporate income taxation in Ireland contained in section 21(1) of the TCA 97. Under the latter, corporation tax is charged on a non-resident company trading in Ireland through a branch or agency “on all its chargeable profits wherever arising.” However, under section 23A, a company was deemed not to be tax resident if (i) it was considered to be tax resident in another country under the application of a double taxation treaty or (ii) the company was listed on a recognised stock exchange or controlled by a person resident in another EU Member State or tax treaty country (relevant companies exception) and those relevant companies or their subsidiaries had a trading activity in Ireland. In relation to the relevant companies exception, there was no requirement that these companies were resident in another country for tax purposes. ASI and AOE fell within the category of companies that could avail of this exception since they were controlled by a company that was resident in a tax treaty country i.e. Apple itself. However, they had no taxable presence in any jurisdiction other than Ireland; not even in the United States where they were considered by Revenue in Ireland to be centrally controlled and managed. Furthermore, the head offices of ASI and AOE lacked any physical presence or employees.

The functions\(^\text{24}\) of the Irish branches of ASI and AOE were presented to Revenue as follows; ASI is responsible for the procurement, sales and distribution of Apple products to related parties and third parties in Europe, the Middle East, India, and Africa (EMEIA) as well as the Asia Pacific (APAC) region. AOE’s branch in Ireland is primarily responsible for the manufacture and assembly of specialised computer products including iMac desktops, Macbooks and other computer accessories. AOE’s Irish branch also provides shared services to other Apple group companies in the EMEIA region with regard to finance, information technology systems and human resources.

In respect of ASI – a tax ruling in 1991 endorsed a method of allocating profits attributable to its branch in Ireland. According to that method, the net profit to be attributed to the branch would be calculated at 12.5% of all branch-operating costs excluding material for resale.\(^\text{25}\) In 2007, a revised calculated the net profit at 10-15% on branch operating costs, excluding costs such as charges from Apple affiliates and material costs.\(^\text{26}\) The 1991 tax ruling in respect of AOE endorsed a method that calculated the net profit to be allocated to the Irish branch at 65% of branch operating costs up to a ceiling of $60-70 million plus 20% in respect of branch operating costs in excess of $60-70 million. However, if the overall profit of AOE’s Irish branch was less than the figure resulting from the formula mentioned above, that lower figure would be used to determine the branch’s net profit.\(^\text{27}\) In 2007, a revised ruling as proposed by Apple and endorsed by Revenue calculated the net profit attributable to the Irish branch as

\(^{24}\) Ibid. Recitals 53-57.

\(^{25}\) Ibid. Recital 59.

\(^{26}\) Ibid. Recital 60.

\(^{27}\) Ibid. Recital 61.
firstly, 10-15% of that branch’s operating expenses, excluding costs such as charges from Apple affiliated companies and material costs. Secondly, an IP return of 1-5% of branch turnover in respect of accumulated manufacturing process technology of the Irish branch and finally a deduction for capital allowances for plant and buildings.28

1.3.3. Excess Profits:
The ‘Excess Profit tax Ruling System’29 allowed Belgian resident companies that are part of a multinational group and Belgian permanent establishments of foreign resident companies that are part of multinational groups to reduce their tax base in Belgium by allowing them to deduct from their actual recorded profits, excess profits. The excess profits were said to arise due to the synergies or economies of scale associated with being a part of a multinational group. The rationale behind this was to ensure that those Belgian group entities were taxed only on their arm’s length profit. This excess profit exemption was granted following a two-step process. Under the first step, the arm’s length prices charged in transactions between the Belgian group entity and its associated enterprises are fixed based on a transfer pricing provided by the taxpayer. The Belgian group entity is regarded at the ‘central entrepreneur’ in these transactions and thus is left with a residual profit. Under the second step, this residual profit is compared with the profits that a standalone company would have made in similar circumstances. This is referred to as the adjusted arm’s length profit. The difference between the residual profit and the adjusted arm’s length profit is the excess profit. This difference is then translated into an exemption percentage of pre-tax profit to achieve an average excess profit percentage. This percentage represents the agreed reduction in the taxable base of the Belgian group entity and is applied under the contested scheme. This is binding on the Belgian tax administration for a period of five years. The legal provision on which the excess profit exemption is based, Article 185(2)(b) of the Belgian Income Tax Code 1992 [hereinafter Article 185(2)(b) WIB 92], specifies that an advance ruling is necessary in order to obtain the exemption. Furthermore, only multinational groups with cross-border operations may benefit from the contested scheme. In addition, according to the Law of 24 December 2002, advance rulings are only available in respect of new situations. Information provided by the Belgian authorities show that 66 rulings were granted to 55 companies since the scheme was introduced in 2004. Evidence also showed that no requests for an advance ruling were refused. The Commission initiated the formal investigation procedure because it took the preliminary view that the Excess Profit exemption scheme constituted a State aid scheme prohibited by Article 107(1) TFEU.

28 Ibid. Recital 62.
2. Chapter Two: Tax Rulings and Transfer Pricing in focus

2.1. Tax Rulings:

The primary focus of this paper is the application of state aid rules to tax rulings in light of the recent judgements in the FFT, Apple and Belgian Excess Profits cases. Accordingly, in this section I will briefly discuss tax rulings on a general basis before proceeding to the legal issues that these measures present in the context of State Aid. Tax rulings can be defined as “written interpretations of tax laws issued by tax authorities to provide clarification of tax arrangements.”

However, a tax ruling may be used to “describe different types of actions with varying characteristics, depending on the corresponding regulatory tax framework.”

It follows that a tax ruling may occur in any form including an ‘Advance Tax Ruling’, an ‘Advance Pricing Agreement’ (APA) or any other type of tax arrangement. The purpose of a tax ruling is “to establish in advance the application of the ordinary tax system to a particular case in view of its specific facts and circumstances.”

The cases that feature in the spotlight of my analysis of tax rulings and state aid primarily concern Advance Pricing Agreements (APA) between the taxpayer and the respective tax administrations. The OECD guidelines define an APA as an advance arrangement determining an appropriate set of criteria for the determination of the transfer pricing of over controlled transactions over a fixed period of time. APAs are “intended to supplement the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing disputes.” These traditional mechanisms have been unable to cope with the substantial increase in the number of transfer pricing disputes between Multinational Enterprises (MNE) and the national tax authorities. This reflects the globalization of economies and undertakings and the growing importance of MNEs to the world economy. In the face of this, APAs “have risen from relative obscurity to become an important transfer pricing controversy management tool” and have been adopted by numerous countries around the world including EU Member States. In addition, tax rulings offer taxpayers “legal security and predictability” which are conducive to attracting investment and compliance.

The rising popularity of APA and other tax agreements signals a shift in the relationship between the taxpayer and tax administrations. Tax rulings envisage an altered and enhanced relationship between the two. This enhanced relationship has been accompanied by a change in mentality – the taxpayer must be treated as a customer. Indeed, Markham describes these agreements as “the institution of individualised, revenue-sanctioned and monitored safe

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32 Commission Notice on the notion of state aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union 2016 O.J. C-262/1 at paragraph169 [hereinafter Commission Notice 2016].
33 M. Markham, Advance Pricing Agreements Past, Present and Future (1st, Kluwer Law International BV, The Netherlands 2012), 18. [hereinafter Markham].
34 Ibid.
35 Moreno González, supra note 31, 561.
harbours.” The relationship that has emerged is one that is more horizontal in its approach and reflects the changing role of tax administrations and tax systems. In addition to fulfilling the States social and basic economic requirements, the tax system and its administrators are increasingly being used to further the economic ambitions of the State and are “being driven by a sense of economic nationalism.”

On the face of it, tax rulings in themselves do not give rise problems for State Aid in particular. The granting of a tax ruling, APA or otherwise, is not prohibited under EU law. In saying that however, the Commission in its 2016 Notice on the notion of State Aid provides the granting of a tax ruling must respect the State aid rules. Member States are free to grant such rulings but the lack of harmonized rules for either the implementation of a tax ruling framework or transfer pricing have brought tax rulings firmly within the scope of EU State aid law and exposed rulings to the scrutiny of the Commission investigations. A tax ruling “may be problematic from a state aid perspective if it: (1) provides certainty on a tax provision which in itself constitutes aid, or if it (2) solidifies an agreement to apply a tax provision in such a way that aid is granted.” Gunn and Luts advance a two-pronged approach in determining whether a tax ruling falls foul of Article 107(1) TFEU. The first question is whether the underlying provisions national law are sound? If the answer is no, then state aid rules come into play at this stage. However, if the answer is yes, then the question to be asked is whether the manner in which the rules have been applied in practice is in line with Article 107(1) TFEU? Answering this question requires the assessment of a selective advantage, which will be discussed shortly in this paper.

2.2. Transfer Pricing:

The need for tax rulings such as APAs has been necessitated by the increased use of transfer pricing in order to determine the taxable income of component members of multinational groups with a presence within a particular tax jurisdiction. In this section, I will discuss the issue of transfer pricing generally inasmuch as it relates to the topic of this paper given it’s significant contribution to the complexity of cases in focus and it’s relevance in the finding of selectivity which will be addressed at a later stage. The relevant tax rulings in FFT and Apple concern large multinational companies with subsidiaries and branches in Luxembourg and Ireland respectively while Excess Profits concerns a regime aimed at attracting multinational groups to Belgium.

The issue of Transfer Pricing has gained global attention in recent years and has been the subject of intense debate. There are a number of factors that have contributed to this. The globalisation of the world economies has been accompanied by the prolific growth of multinational enterprises (MNE). The increasing level of cross-border transactions has facilitated the growth in aggressive tax planning. In the context of the global and European

36 Markham, supra note 33, 2.
37 Ibid. 9.
39 Ibid.
financial crisis, the focus on transfer pricing “has been amplified during recent years as States are under pressure to levy taxes and reduce their public deficits.”\textsuperscript{40} While it is clear that countries have a legitimate right to tax profits of companies on the basis of their own tax principles, this needs to be balanced with “the need to avoid the taxation of the same item of income by more than one tax jurisdiction.”\textsuperscript{41} However, the task of allocating profits to associated enterprises within one tax jurisdiction is fraught with difficulty given the need to obtain information concerning transactions that may have arisen in another tax jurisdiction. When two independent companies do business together, the prices for such transactions are usually determined by market forces i.e. supply and demand. Indeed, the taxable income of each of the parties to the transaction “is directly influenced by the prices of the transactions.”\textsuperscript{42} Such transactions are referred to as ‘uncontrolled transactions.’ It is possible to directly observe from the company’s accounting profit the correlation between the taxable income and the price paid. However, when associated enterprises do business together, their relationship may influence the price paid for the transactions and not as susceptible to market forces as two independent enterprises with no legal or economic connections. These transactions are commonly known as ‘uncontrolled transactions.’ This may result in the price of uncontrolled transactions to deviate from what would have been the price agreed between independent enterprises.\textsuperscript{43} Thus, transfer pricing refers to those prices “at which an enterprise transfers physical goods or intangible property or provides services to associated enterprises.”\textsuperscript{44}

2.2.1. The Arm’s Length Principle:

In order to eliminate the effects of the special conditions that exist between associated enterprises, States have adopted the arm’s length principle (ALP). The arm’s length principle dictates that the prices for transactions between two related companies should resemble those prices paid for by independent enterprises in a similar transaction. In other words, the prices should be in line with the market price. It necessarily involves a fiction in that it treats associated enterprises as independent enterprises and aims to correct the deviations that may arise as a result of being part of a multinational group. It is regarded as the international standard in the determination of transfer prices. It is enshrined in Article 9 of the OECD Model Tax Convention on Income and Capital [hereinafter OECD Model Tax Convention]. However, it is also contained in Article 9 of the United Nations Model Double Tax Convention between Developed and Developing Countries. While these are non-binding on Member States, they are a tour de force in influencing the tax policies of countries. In the European Union, Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, also gives recognition to the arm’s length standard through Article 4(1). This was agreed on an intergovernmental

\textsuperscript{40} J. Monsenego, \textit{Introduction to Transfer Pricing} (1st, Kluwer Law International BV, The Netherlands, 2015), section 1.1; [hereinafter Monsenego].
\textsuperscript{41} OECD Guidelines 2017, \textit{supra} note 17, page 15.
\textsuperscript{42} Monsenego, \textit{supra} note 40, at section 1.1.
\textsuperscript{43} Ibid.
\textsuperscript{44} OECD Guidelines 2017, \textit{supra} note 17 at page 20.
basis given the exclusivity of competences in relation tax matters resting with the Member States.

So how does the arm’s length principle work? Transactions between two associated enterprises are tested against the arm’s length principle. If it is “demonstrated that the intercompany prices differ from those applied to comparable transactions between independent companies, the multinational enterprise should adjust its transfer prices in order to implement the arm’s length principle.”

The competent authority usually retains a right to reassess the taxable income of the undertaking concerned, if it deems that it is not in line with the arm’s length principle. In that sense, it can be regarded that a key aim of the arm’s length principle is “to promote equity and fair competition between independent taxpayers and related taxpayers.”

However, the arm’s length principle is not without its flaws and this has been recognised by the OECD. Kofler notes that the arm’s length principle “originally developed in a low tech, bricks-and-mortar economy and...is largely viewed as dysfunctional in a globalised, high-tech economic environment, especially with regard to intangibles.”

It overly relies on data from independent comparable enterprises and transactions and makes the assumption that both associated enterprises and independent enterprises are inherently the similar. This may not reflect the reality of the relations between two associated enterprises. The transactional approach necessarily ignores the natural synergies and economies of scale that are achieved by being part of a multinational group and thus leading to a false economic reality.

At the heart of the arm’s length principle is the comparability analysis. According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 [hereinafter OECD Guidelines], there are two key aspects in a comparability analysis, the first is to identify the commercial or financial relations between the associate enterprises and the conditions and economically relevant circumstances attaching to those relations in order the that the controlled transaction is accurately delineated. Secondly, compare the conditions and economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and economically relevant circumstances of comparable transactions between independent enterprises.

In other words, identify first the role played by the associated enterprise within the multinational group. This is referred to as the functional analysis and forms part of the comparability analysis on which transfer prices are determined. In relation to the functional analysis, the OECD Guidelines identifies three factors to be taken into account, namely the functions performed, the risks assumed and the assets used. This focuses on what the parties to the transaction actually do and the capabilities they provide. This includes decision making about business strategy and risks. Indeed, the “more important the functions are performed, the more significant risks are

45 Monsenego, supra note 40 section 1.2.3.
46 Ibid. section 1.3.
48 OECD Guidelines 2017, supra note 17, page 44.
49 Monsenego, supra note 40, section 1.4.1.
50 OECD Guidelines 2017, supra note 17, page 51.
assumed, and the more valuable the assets are used, the more exposed an associated enterprise should be to the economic outcome of an intercompany transaction.\textsuperscript{51}

Following the functional analysis, it is necessary to engage in a comparability analysis in order to determine the transfer price. This involves comparing the prices paid by the associated enterprise in a controlled transaction with the price paid by an independent enterprise in an uncontrolled transaction or alternatively, it will be the profits earned by an associated enterprise that will be tested against those earned by comparable independent enterprises.\textsuperscript{52} This is then compared to an arm’s length range. If within this arm’s length range, it would be regarded as being in line with the arm’s length principle as stated by the OECD Guidelines.\textsuperscript{53}

\textit{2.2.2. Transfer Pricing Methods:}

Setting a transfer price necessarily depends on the employment of a transfer pricing method. According to the OECD Guidelines, the selection of the transfer pricing method “aims at finding the most appropriate for a particular case.”\textsuperscript{54} In selecting a transfer pricing method, account should be taken of strengths and weaknesses of the recognised OECD methods; the appropriateness of the method in view of the nature of the controlled transaction; the availability of reliable information and the degree of comparability between controlled and uncontrolled transactions.\textsuperscript{55} Indeed, the Guidelines note that transfer pricing is not an exact science and no one method is suitable in every situation. The OECD Guidelines describe five methods for determining transfer prices: (1) the comparable uncontrolled Price (CUP) method; (2) the resale price method; (3) the cost plus method; (4) the transactional net margin method (TNMM); (5) the transactional profit split method. The first three methods are referred to as the ‘traditional’ methods while the remaining are known as ‘transactional’ profit methods. Traditional methods are regarded as being the most direct method of establishing whether the conditions in the commercial and financial relations between associated enterprises are at arm’s length. Any difference in price between controlled and a comparable uncontrolled transaction can be seen directly and attributed to the commercial and financial relations between the companies. Indeed, the OECD Guidelines specify a preference for the CUP method in particular when comparable uncontrolled transactions can be located.\textsuperscript{56}

However, these are not appropriate in all circumstances and the transactional methods will be more suitable where none of the parties makes a unique and valuable contribution. Furthermore, the OECD Guidelines that the choice of method is only acceptable insofar as it adheres to the arm’s length principle.\textsuperscript{57} However, a company retains the freedom to apply

\textsuperscript{51} Monsenego, \textit{supra} note 40, section 1.4.1.
\textsuperscript{52} \textit{Ibid.} section 1.4.2.
\textsuperscript{53} OECD Guidelines 2017, \textit{supra} note 17, paragraph 3.60.
\textsuperscript{54} \textit{Ibid.} paragraph 2.2.
\textsuperscript{55} \textit{Ibid.} paragraph 2.2.
\textsuperscript{56} \textit{Ibid.} paragraph 2.15.
\textsuperscript{57} \textit{Ibid.} paragraph 2.6.
methods that are not described in the Guidelines as long as such methods achieve an outcome that is in line with the arm’s length principle.

I will now discuss the transactional net margin method (TNMM) as described in the OECD Guidelines insofar as it of significant relevance in the Commission decisions in the FFT, Apple and Excess Profits cases. TNMM is a one-sided transfer pricing method, in other words, only one of the parties to the transaction is tested. It assesses the net profit relative to an appropriate base e.g. costs, sales or assets, that a taxpayer realises from a controlled transaction. It requires that the selected net profit indicator of the taxpayer from a controlled transaction should be established by reference to the profit indicator earned by the same taxpayer in a similar uncontrolled transaction – an internal comparable. When this is not possible, the taxpayer may establish the profit level indicator by reference to uncontrolled transactions between two independent enterprises – an external comparable. Furthermore a functional analysis is required to determine whether the controlled and uncontrolled transactions are comparable.\(^58\) Thus, the choice of profit level indicator necessarily depends on the activities carried out by the tested party. However, the Guidelines note that TNMM is unlikely to yield reliable results where each party to the transaction makes a unique and valuable contribution. Indeed, TNMM should only be applied “if the tested party does not develop or own intangibles as part of that transaction.”\(^59\) Thus, where one party makes all the unique and valuable contributions, TNMM may be appropriate. The Guidelines specify that in such a case, the least complex party should be the tested party.\(^60\) In cases where other transfer pricing methods cannot be relied upon because sales or the cost of goods sold (COGS) are related to transactions with associated enterprises, the Berry Ratio may be applied. This relates the gross margin to the operating expenses.\(^61\)

However, it is worth noting that the OECD Guidelines and the Model Tax Convention are non-binding on Member States. Indeed, there are varying degrees of application of the OECD Guidelines and different transfer pricing requirements that apply from country to country resulting from differences in interpretation of the Guidelines. In that respect, the OECD Guidelines can best be regarded as a framework to analyse transfer-pricing issues. This is equally true for EU Member States. Commentators have note “the general institutionalisation process in international taxation is still in its infancy and is characterised by a low level of harmonisation regarding cross-country procedures.”\(^62\) Indeed, within the European Union itself, there is a lack of harmonised transfer pricing rules due to the fact that direct taxation is an exclusive competence of the Member States. This patchwork has resulted in increased compliance costs and possible over-taxation of multinational groups and general uncertainty for undertakings. Furthermore, the relationship between the OECD Guidelines and EU law is not entirely clear. The EU itself is not an OECD member but the Joint Transfer Pricing

\(^{58}\) Ibid. paragraph 2.64.

\(^{59}\) Monsenego, supra note 40, section 2.3.1.

\(^{60}\) OECD Guidelines 2017, supra note 17, paragraph 2.65.

\(^{61}\) Monsenego, supra note 40, section 2.3.1.

Forum endorsed the OECD Guidelines as the standard to be followed by EU Member States but this given this is also not binding on Member States, a question then arises as to what is the legal source of the arm’s length principle? This question is extremely relevant in terms of the Commission decisions in relation to tax rulings in FFT, Apple and Excess Profits and the approach taken by the Commission has come as a surprise to many as will be outlined at a later stage.

3. Chapter Three: Approach by the Commission in satisfying the conditions of Article 107(1) TFEU – A novel approach?

As outlined earlier in Chapter One of this paper, a finding of illegal State aid under Article 107(1) TFEU requires four cumulative criteria to be satisfied namely; (1) The measure must confer an advantage; (2) this advantage must only be conferred upon certain undertakings or production of certain goods – it must be selective; (3) the advantage must be granted through State resources; (4) the measure must distort or threaten to distort competition in the internal market and affect trade between the Member States. The nature of tax rulings means the third and fourth criteria are quite easily satisfied in almost instance.

3.1. Granted Using State Resources:

For a measure to come within the scope of Article 107(1) TFEU, the aid must have been granted by the State using State resources. A measure is imputable to the State where “where a public authority grants an advantage to the beneficiary.”63 This applies equally if the public authority delegated certain powers to other public or private bodies. Imputability to the State is quite easily satisfied in the context of tax rulings as the tax authority of the Member State at issue generally grants the contested rulings. However, only advantages that are granted directly or indirectly through State resources can constitute State aid. However, in addition to the explicit statement provided in Article 107(1) TFEU that aid can be granted in any form whatsoever, the 2016 Notice specifically provides that a positive transfer of funds does not need to occur but where the State foregoes resources that otherwise would have been due it, this constitutes a transfer of state resources.64 In the decisions in FFT, Apple and Excess Profits, the Commission alleges that the contested rulings result in a lower corporate tax burden in the Member States concerned i.e. a loss in State resources.

3.2. The measure must distort or threaten to distort competition and must affect trade between Member States:

Firstly in relation to the criterion that the measure must distort or threaten to distort competition in the internal market and affect trade between Member States; the 2016 Notice specifies that these are two distinct and necessary elements of the notion of aid. Even though in practice, these are assessed jointly, both elements must be satisfied.

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63 Commission Notice 2016, supra note 32, paragraph 39.
64 Ibid. paragraph 51.
3.2.1. Distortion of competition:

The Notice states that a measure distorts or is likely to distort competition “when it is liable to improve the competitive position of the recipient compared to other undertakings with which it competes.”\(^{65}\) Furthermore, the aid does not have to help the undertaking expand or gain market share but is enough that the aid allows the recipient “to maintain a stronger competitive position than it would have had if the aid had not been provided.”\(^{66}\) In the Commission decisions in *FFT*, *Apple*, the finding that a tax ruling relieved the undertakings concerned from a burden they would have otherwise be obliged to bear by reducing their corporate tax liability in the Member state at issue, was enough to establish that the contested rulings distorted or were liable to distort competition.\(^ {67} \)\(^ {68} \) A similar finding was made in *Excess Profits*, where the Commission found the contested scheme to distort or liable to distort competition in that it lead to a reduction in the corporate tax liability for those undertakings that benefitted under the scheme.\(^ {69} \)

3.2.2. Affect trade between Member States:

According to the 2016 Notice, a measure is likely to affect trade between Member States “where the State financial aid strengthens the position of an undertaking as compared with other undertakings competing in intra-[Union] trade.”\(^ {70} \) Furthermore, it is not necessary to establish that there actually is an affect on intra-Community trade but it is sufficient to show that it is likely. The Commission decisions in *FFT* and *Apple* concern large multinational enterprises with a global presence while the Excess Profit Exemption Scheme applied to multinational companies only in respect of cross-border transactions so this element is easily satisfied in this context.

Therefore, a finding of State aid in relation to a tax ruling hangs on whether it can be established that the contested ruling confers an economic advantage and that advantage was granted selectively. The nature of tax rulings necessarily means that a finding of State aid for the purposes of Article 107(1) TFEU is effectively reduced to an examination of two of the four criteria. This should not be taken as verbatim, there may be cases in which the distortion and State resources criteria are not so easily satisfied but in cases where a tax ruling is granted by the tax authority of an EU Member State to a multinational enterprise such as Apple, those criteria are fulfilled with relative ease. There is nothing problematic about this aspect in itself but in the context of the approach taken by the Commission, it raises a number of interesting issues.

The approach taken by the Commission in *FFT* and *Apple* and *Excess Profits* represents a new development in an examination of tax rulings for State aid purposes. The Commission stated in the decisions, that its assessment of whether the contested measure derogates from

\(^{67}\) *FFT* Final Decision, *supra* note 21 at Recital 188.
\(^{68}\) *Apple* Final Decision, *supra* note 23 at Recital 222.
\(^{69}\) *Excess Profits* Final Decision, *supra* note 29 at Recital 116.
\(^{70}\) Commission Notice 2016, *supra* note 32 at paragraph 190.
the reference system (the second step of the selectivity analysis) coincides with its assessment of whether those measures confer an advantage. It says that it’s purpose for doing so stems from the fact that the identification of the advantage requires a comparison economic position of the undertakings concerned that had obtained a tax rulings with those undertakings that did not while the identification of a derogation involves comparing the economic position of the recipient of the advantage with those undertakings that are in a similar legal and factual situation in light of the objectives of the reference system and have not been conferred the advantage. The Commission appears to justify this approach on the basis of the judgement of the CJEU in the MOL case. In that case, the Court noted “that the selectivity requirement differs depending on whether the measure in question is envisaged as a general scheme of aid or as individual aid.” In the case of individual aid, the Court said that “the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective.” It is questionable whether this represents an appropriate avenue to establish selectivity “given the exclusive competence of Member States with regard to direct taxes and the fact that the other criteria contained in Article 107(1) TFEU are almost always satisfied.” As is seen in the decisions, this has the effect of reducing the question of whether a selective advantage arises to essentially whether the contested tax ruling complies with arm’s length principle. Kryiazis notes that the fact that the Court has established this presumption “does not mean that these two State aid conditions become one, but merely that in principle, i.e. not always, the fulfillment of the advantage condition creates (a rebuttable) presumption that the (separate) selectivity condition is also fulfilled.” However, in terms of a unilateral tax ruling as is the case in Apple, rebutting this presumption is almost impossible. Indeed, the approach leaves (rightly or wrongly) very little leeway for States to argue that the contested rulings were not selective.

### 3.3. Economic Advantage:

The Commission’s approach thus relies substantially on establishing the existence of an economic advantage. However, it appears that establishing an advantage has evolved from being one of four cumulative steps in the process of establishing State aid within the meaning of Article 107(1) TFEU, to forming a constituent element within the Commission’s three-pronged derogation test to establish selectivity as be outlined shortly. The 2016 Notice defines an advantage within the meaning of Article 107(1) TFEU as “any economic benefit which an undertaking could not have obtained under normal market conditions, that is to say in the absence of State intervention.” It clarifies that where the financial situation of an undertaking is improved as a result of State intervention on terms differing from normal

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71 FFT Final Decision, supra note 21 at Recital 217;  
72 Apple Final Decision, supra note 23 at Recital 224.  
73 Excess Profits Final Decision, supra note 29 at Recital 131.  
75 Ibid. paragraph 60.  
76 Ibid.  
77 Moreno González, supra note 31, 566.  
79 Commission Notice 2016, supra note 32, paragraph 66
market conditions, an advantage is present. The 1998 Notice on business taxation further clarified that an advantage is conferred when a measure relieves them of charges that are borne from their budgets. Thus, a tax ruling could only convey an advantage “if a company would pay less taxes with the ruling than it would without.” What is clear from the decisions in FFT, Apple and to a lesser extent Excess Profits is that the Commission focuses almost exclusively on this aspect and uses the same evidence to establish both the presence of advantage and selectivity. In order to determine whether or not an advantage has been conferred, it is necessary to determine what the economic position of the undertaking concerned would have been if the contested ruling had not been granted i.e. the ‘normal’ burden of tax that is borne by the company. Presumably this necessitates looking at what would have been its tax burden under the tax provision applicable to it. Kyriazis observes that in a case where the Member State in question has not implemented the arm’s length principle, “then the company would have been taxed under the relevant “ALP-agnostic” tax provision.” However, as will be seen, the Commission seems to disregard this factor in the case of Apple.

4. Chapter Four: Establishing a selective advantage – the selectivity criterion re-imagined

4.1. Introduction:

In this chapter, I will hone in on the selectivity criterion in the application of Article 107(1) TFEU to tax rulings. This process is far from straightforward, not least in the context of tax rulings. An analysis of the selectivity requirement “involves not only an analysis of the tax measure under consideration, but also a close scrutiny of the general tax system in which the measure applies.” It will be a decisive factor in whether the measure i.e. the tax ruling constitutes State aid for the purposes of Article 107(1) TFEU. In general, the area of direct taxation poses a challenge in establishing selectivity. As outlined earlier, there are 28 different tax systems at present across the European Union, each with standards and principles peculiar to it. The depth and breadth of tax rules in force across the EU presents difficulties in establishing a single formula on which to apply selectivity to a tax measure. Furthermore, it is worth pay attention to the de jure/de facto distinction at this point. A de jure exception to a tax rule explicitly confers such an advantage to a certain category of undertakings, while a de facto selectivity “encompasses measures which apply in principle to any undertaking, but are in practice only available to a restricted number of undertakings.” Applying this in the area of tax rulings remains all the more challenging given the individual nature of rulings within the frame of the national tax system, even if the possibility to obtain such a ruling, in principle, is open to all undertakings.

80 Ibid. paragraph. 9.
81 Gunn & Luts, supra note 38, 120.
82 Kyriazis, supra note 78, 434.
83 Micheau, supra note 30, , 324.
84 Ibid., 325.
4.2. The ‘Three-Step Derogation Test’:

Selectivity in essence requires a determination of whether a measure favours a certain undertaking or group of undertakings over others. In effect, this requires the identification of all the potential beneficiaries of a measure. This is less than straightforward given that a tax measure may affect different economic operators differently in the sense that an undertaking may be directly or indirectly affected by a particular tax measure. The traditional Commission approach to establishing selectivity attempts to identify such undertakings. The Commission has developed a three-step approach to assess selectivity. Firstly, the Commission identifies the ‘reference system.’ Secondly, the Commission whether the tax measure derogates from this reference system in light of the objectives pursued by that system and finally, the Commission asks whether the measure can be justified by the nature and the general scheme of the reference system.

4.2.1. Identification of the Reference System:

The first step in the three-pronged approach traditionally taken by the Commission in establishing the selectiveness of a fiscal measure; is the identification of the reference system. It constitutes “the benchmark against which the selectivity of measure is assessed.”\(^85\) The 2016 Notice, defines the reference system as a “consistent set of rules that generally apply – on the basis of objective criteria – to all undertakings falling within its scope as defined by its objective.”\(^86\) Furthermore, the 2016 Notice specifies that in relation to tax measures, the reference system is based on such elements as the tax base, the taxable persons, the taxable event and the tax rates.\(^87\) This potentially includes a broad range of undertakings and thus presents a challenge in terms of tax rulings. A key challenge for the Commission in this regard is to strike “a balance between a too broad framework and a too narrow one.”\(^88\) Indeed, framework that is too broad may result in any general measure being construed as selective, while a narrow framework has the opposite effect and results in a dilution of the selectivity element.

A critical question in relation to the identification of the reference system is thus, what categories of undertakings are affected by the tax measure? It is only when this question has been answered that a comparison can take place between them in order to assess the selectiveness of a measure. EU practice has provided at all undertakings that are in a similar legal and factual situation. In that regard, attention should be paid to the internal/external comparison distinction.\(^89\) In the Adria-Wien Pipeline\(^90\) case, the CJEU ruled that a rebate of

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85 Commission Notice 2016, supra note 32, paragraph 132
86 Ibid. paragraph 133.
87 Ibid. paragraph 134.
88 Micheau, supra note 30, 333.
energy taxes on natural gas and electricity was available only to undertakings whose primary activity was the manufacture of goods, was selective. The measure primarily affected undertakings in the primary and secondary sectors. However, the CJEU found that undertakings in the tertiary sector were in a similar legal and factual situation in light of the objective pursued by the measure, namely to reduce consumption of energy for environmental purposes. Drabbe notes, the CJEU did not limit its analysis to an internal comparison (i.e., the tax treatment of energy consumption applied to undertakings manufacturing goods)\(^91\) but rather “took a step further by carrying out an external comparison between the tax treatments on energy consumption applicable to all undertakings in light of the environmental objectives of the measure.”\(^92\)

Any comparison between undertakings must be done in light of the objective of that reference system. The case law of the CJEU refers to two related albeit slightly different versions. On one hand, some CJEU case law refers to a comparison of all undertakings in a similar legal and factual situation in light of the objectives pursued by the measure in question, as was the case in *Adria-Wien Pipeline*\(^93\) On the other hand, some cases refer to a comparison in light of the objective pursued by the system. In the *Commission v. Gibraltar*, the CJEU stated that Article 107(1) requires a comparison of undertakings in a similar legal and factual situation “in the light of the objective pursued by that regime.”\(^94\) Micheau notes that nuanced approach can yield different outcomes.\(^95\) This is particularly pertinent to our discussion as an analysis based on the objective pursued by the measure i.e. the tax ruling, can lead to a significantly different outcome than assessment based on the objective pursued by the regime. Furthermore, the Court in the *Commission v. Italy* stated that Article 107(1) “does not distinguish between the measures of State intervention concerned by reference to their causes or aims but defines them in relation to their effects.”\(^96\) In that respect, an assessment based on the objective pursued by the measure or the regime seems out of step with the CJEU in the *Commission v. Italy*. In the cases of *FFT*, *Apple* and *Excess Profits*, the Commission makes reference to the objectives pursued by the system but as we will see, it does at points make reference to the objective pursued by the measure. It is questionable whether the objectives pursued by the measure and the objectives pursued by the regime are mutually exclusive.

Turning to the approach taken by the Commission in the *FFT*, *Apple* and *Excess Profits*, it is clear that the Commission remained loyal to the approach followed in previous cases in relation to the identification of the reference system. Indeed, the approach taken by the Commission in these cases is similar in many aspects and contains many of the same elements. The following principles can be inferred from the judgements in *FFT*, *Apple* and *Excess Profits*:

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\(^{91}\) *Ibid.* paragraph 6.03

\(^{92}\) *Ibid.*

\(^{93}\) *Adria-Wien Pipeline*, *supra* note 90, paragraph 41.


\(^{96}\) *Commission v. Italy*, *supra* note 2, paragraph 13.
4.2.1.1. The Reference System comprises of the general rules on corporate income taxation of the Member State.

Firstly, the Commission considered that the appropriate reference system was the general corporate income tax systems of Luxembourg\textsuperscript{97}, Ireland\textsuperscript{98} and Belgium.\textsuperscript{99} This appears to be based primarily on the approach taken by the CJEU in the \textit{Paint Graphos} case. In that case, the CJEU stated that “for the purposes of calculating corporation tax, the basis of assessment of the producers’ and workers’ cooperative societies concerned is determined in the same way as that of other types of undertaking...corporation tax must therefore be regarded as the legal regime of reference for the purpose of determining whether the measure at issue may be selective.”\textsuperscript{100} It appears that the Commission has chosen a very broad reference framework against which the contested tax rulings will be measured against to determine whether or not such rulings are selective. Thus it can be said the Commission has chosen to take an external comparison of undertakings i.e. the undertaking granted the tax ruling versus those companies who were not granted such rulings. Furthermore, in all three cases the Commission considered that the intrinsic objective underpinning the corporate tax systems was the taxation of profits of all companies that derived income in the State in question. From that we can infer that the Commission regards the manner in which a company derives its profit as irrelevant in the determination of the reference framework. In the context of tax rulings, this may be a major contributing factor in the finding of selectivity accompanied by a framing of the reference system in terms of the wider corporate tax system.

4.2.1.2. Integrated and non-integrated companies are in a similar legal and factual situation:

In the cases of \textit{FFT}, \textit{Apple} and the \textit{Excess Profits} case, the Commission regarded the ‘reference system’ as comprising of both integrated and non-integrated companies. In \textit{FFT}, the Commission stated, “neither the legal form of the undertaking nor its structure of the company constitute a determinant criterion for the imposition of corporate tax in Luxembourg.”\textsuperscript{101} This is due to Luxembourg tax law levying tax on individuals and not on groups and thus, an approximation of FFT’s taxable profit, is to levy Luxembourg corporate income tax on that company alone. Similarly, in \textit{Apple}, the Commission found that the Irish corporate tax system does not distinguish between undertakings that derive their profits from market transactions only and those undertakings that derive profits through intra-company transactions.\textsuperscript{102} The same conclusion was reached in the \textit{Excess Profits} case.\textsuperscript{103} It regarded all those taxpayers as being in a comparable legal and factual situation. In the three cases the Commission said the fact that the taxable profits of integrated and non-integrated companies are determined in a different manner does not alter that conclusion. It attributed these

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\textsuperscript{97} FFT Final Decision, \textit{supra} note 21, Recital 194.
\textsuperscript{98} Apple Final Decision, \textit{supra} note 23, Recital 228.
\textsuperscript{99} Excess Profits Final Decision, \textit{supra} note 29, Recital 121.
\textsuperscript{100} Judgment of 8 September 2011, \textit{Paint Graphos}, Joined Cases C-78/08 to C-80/08, ECLI:EU:C:2009:417, paragraph 50.
\textsuperscript{101} FFT Final Decision, \textit{supra} note 21, Recital 198.
\textsuperscript{102} Apple Final Decision, \textit{supra} note 23, Recital 229.
\textsuperscript{103} Excess Profits Final Decision, \textit{supra} note 29, Recital 126.
differences in deriving taxable profits with the inability to observe the taxable profits of integrated companies in a reliable way from the statutory accounts whereas in the case of non-integrated companies it is possible to directly observe and calculate the taxable profit as it based on market transactions. The Commission described this difference in the calculation of taxable profits as “a means by which to achieve the ultimate goal of determining the taxable base of both types of companies in a manner that ensures that integrated companies are taxed on an equal footing to non-integrated companies under the ordinary rules of taxation of corporate profit.”

Companies FFT and Apple, argued in the respective decisions that the refusal of the Commission to acknowledge the integrated/non-integrated distinction was out of line with its own previous decisions. In the FFT, the company asserted that in order to establish selectivity, the Commission must demonstrate that FFT obtained a tax ruling under conditions that are different from those of other Luxembourg group entities engaged in financing activities. It appears that FFT wanted the Commission to restrict itself to an internal comparison of undertakings. In support of its claim, FFT argued that the Commission decisions of Groepsrentebox and Hungarian Group endorsed this approach. In the Groepsrentebox, the Commission acknowledged that in light of the objective pursued by that measure, related companies engaged in debt financing activities are not in a comparable legal and factual situation as unrelated companies. The reason it said was due to the fact that related companies are not engaged in a merely commercial transaction, unlike unrelated companies, when they try to obtain loan or equity financing within the group. The parent and the subsidiary share the same interests, which is not the case of a commercial transaction with a third-party provider of finance, where each party tries to maximise its profits at the expense of the other. It considered the reference system in that case to comprise only of group companies engaged in debt financing activities. The same conclusion was reached in the Hungarian Group case. The Commission dismissed these assertions and reminded the parties that it is not bound by its own decisions. It said that the objective of the measure at issue in both of the aforementioned decisions is not comparable to the cases at hand. It said the objective of the contested tax rulings at issue was to approximate a profit for the group entities for the purposes of levying corporation tax on such profits in the respective Member States. In that regard, the Commission does not consider integrated and non-integrated companies to be in a different legal and factual situation.

The distinction or lack thereof, between integrated and non-integrated companies raises an interesting issue in relation to tax rulings. Luja refutes the assertion that group companies and

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104 Apple Final Decision, supra note 23, Recital 230.
105 Ibid. 230.
106 FFT Final Decision, supra note 21, Recital 201.
107 Commission Decision 8 July 2009, on the Groepsrentebox scheme which the Netherlands is planning to implement, OJ L 288, 04.11.2009; [hereinafter; Groepsrentebox].
109 Groepsrentebox, supra note 107, Recital 103.
110 Ibid.
111 Hungarian Group, supra note 108, Recital 111.
standalone companies are in a comparable legal and factual situation. If are to treat them alike he says; “we would have to operate from a presumption that any dealings with other companies will be uninfluenced by any interpersonal relationships.”\textsuperscript{112} Furthermore, he notes that it is “because of this interrelation between group members that most national tax laws provide specific rules to counter tax avoidance...”\textsuperscript{113} The Commission claims that the aim of the contested measures is correct deviations created by associated companies having relations and to put them on an equal footing with standalone enterprises in terms of taxation. However, the converse is also true. Transfer pricing exists because transactions between two related enterprises are fundamentally different to those between two independent enterprises where profits are determined by market forces. By turning this reality on its head and framing it within the objective of determining corporate tax liability, the Commission manages to escape a discussion of whether a comparison should be limited to companies which make use of transfer pricing methods in deriving their taxable profits. This is despite the fact that it has acknowledged in previous decisions, even in those very limited circumstances; that integrated and non-integrated companies are not in a similar legal and factual situation. It appears disproportionate to simply dismiss that fact on the basis of not being bound by its decisional practice. In spite of the rather broad and all-encompassing reference system of the general corporate income tax system of the Member State with its objective being the taxation of all company profits, it seems even more pertinent that the Commission should seek to concretely establish the criteria for comparing undertakings and be careful not to compare apples with oranges, no pun intended.

4.2.1.3. Rules on residency have no bearing on the determination of the reference system:

In Apple, that company and the Member State concerned, Ireland, argued that non-resident companies are not in a comparable legal or factual situation. As set out previously, Section 23A TCA 97, provided an for exception to the general corporate tax rules allowing the branch of a company not resident in Ireland, to be incorporated in Ireland without being resident in Ireland for tax purposes and whilst only being subject to income tax on trading income arising directly or indirectly through or from an Irish agency or branch. While accepting the explicit distinction made between resident and non-resident branches under Irish law, the Commission did not deem this sufficient to justify the identification of reference system distinct from the ordinary corporate tax system.\textsuperscript{114} In the eyes of the Commission, the fact that ASI and AOE are Irish branches of non-resident companies does not warrant differentiating tax treatment as they “generate income and profits just like any other resident company engaged in a trading activity and, in the case of source income from the production or sale of goods and services in Ireland, both resident and non-resident companies are taxed on the same type of income.”\textsuperscript{115} The Commission asserted that case law

\textsuperscript{112} R. Luja, ‘State Aid Benchmarking: Can We Keep It Simple’ in Isabelle Richelle, Wolfgang Schöne et al (eds), \textit{State Aid Law and Business Taxation} (1st ed., Springer-Verlag, Berlin Heidelberg 2016) at section 2.2.

\textsuperscript{113} Ibid.

\textsuperscript{114} Apple Final Decision, supra note 23, Recital 237.

\textsuperscript{115} Ibid. Recital 238.
of the CJEU supported the view that resident and non-resident companies are in a similar legal and factual situation as regards the method for determining a taxable base. It pointed to the cases of *Royal Bank of Scotland* 116 and *CLT-UFA* 117 as a confirmation of this. In that case, Greece imposed open banks having their seat in another Member State, a taxation rate of 40% whereas a bank having its seat in Greece paid a rate of 35%. The Court stated that “[as] far as the method of determining the taxable base is concerned, the Greek tax legislation does not establish...any distinction such as to justify a difference of treatment between the two categories of companies.” 118 A similar conclusion was reached by the CJEU in *CLT-UFA*.

In its concluding remarks on the reference system in the *Apple* case, the Commission stated that the ultimate goal of the exercise conducted for the purpose of the contested tax rulings is to arrive at an annual taxable profit for ASI and AOE that ensures that non-resident companies are taxed on their locally-sourced income in a similar manner to non-integrated resident companies. Firstly, it is curious that the Commission refers to the objective pursued by the tax ruling in question given the effects based principle that underpins Article 107(1) TFEU. The CJEU has clarified on numerous occasions that Article 107(1) TFEU “does not distinguish between the measures of State intervention concerned by reference to their causes or aims but defines them in relation to their effects.” 119 Notwithstanding the fact that the Commission considered that the reference system consisted of the general Irish corporate tax rules with its objective of the taxation of all profits of companies in Ireland. Secondly, the Commission is contending that a company that extends itself across a border through its branch, is in the same position as a company which does not expose itself to more than one tax jurisdiction. Wattel observes that this necessitates the need for the prevention of double taxation and since no rules on EU level currently exist, Member States are free to apply both the residence principle for their residents and the source principle for non-residents. 120 He notes that there is not even a rule of EU law which prohibits double taxation within the EU itself. In his opinion therefore, “there is an objective difference between a taxpayer staying at home and a taxpayer exposing himself to two taxing jurisdictions.” 121 It appears the Commission may have been driven by the fact that ASI and AOE were not resident in any other taxable jurisdiction besides Ireland and thus any profit allocated to its head offices were not taxable in Ireland. However, this peculiarity was permitted under Irish law. In addition, the CJEU has recognised the principle of territoriality in terms of taxation. 122 However, the Commission curiously did not challenge the compatibility of Section 23A TCA 97 with Article 107(1) TFEU. While the moral objections to this are quite valid, State aid does not concern itself with the morality of contested measures. While the approach of the Commission appears to be in line with it’s own decisional practice and the case law, it seems

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120 Peter J. Wattel, 'Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality' [2003 ] 4 E.C. Tax Review 194, 198
121 Ibid. 199.
it is based upon what it deems to be the objective pursued by the measure in question namely, to ensure equal tax treatment between non-integrated and integrated companies in respect of locally sourced income.

4.2.1.4. The Arm’s Length Principle forms part of the reference framework:

It is clear from the Commission decisions that the arm’s length principle will form an essential part of the reference framework and will be used by the Commission as a benchmark to determine whether a measure derogates from the normal system of taxation.

In the case of FFT, the Commission said that its assessment consists of verifying whether “the methodology accepted by the Luxembourg tax administration...departs from a methodology that leads to a reliable approximation of a market-based outcome and thus from the arm’s length principle, that ruling will be found to confer a selective advantage.”

In Excess Profits it found that the Excess Profit exemption “to constitute a misapplication of and thus a deviation from the arm’s length principle, which forms part of that system.” In both the FFT and Excess Profits cases, the Commission considered that arm’s length principle was embedded in the legal system of the Member State at issue. However, this was not the situation in the Irish context. At the time of the contest tax rulings, there were no transfer pricing rules in Ireland and in that respect, there was no arm’s length principle ingrained in the Irish legal system. In fact, Ireland disputed the existence of the arm’s length principle with regard to Section 25 TCA 97. In the Apple case, the Commission asserted that in order “to ensure that a profit allocation method endorsed by a tax ruling does not selectively advantage a non-resident company operating through a branch in Ireland, that method must ensure that that branch’s taxable profit...is determined in a manner that reliably approximates a market-based outcome in line with the arm’s length principle.” It clarified that in the context of fiscal aid measure, the Commission uses the arm’s length principle as “a benchmark” and the principle it applies flows from Article 107(1) TFEU as interpreted by the Court of Justice and that the principle “applies independently of whether the Member State question has incorporated the arm’s length principle in its national legal system.”

It is questionable whether this is appropriate since the point of establishing the reference system is to determine what the ‘normal’ tax system would be, which must be established by reference to the tax system of the Member State at issue. Therefore, it may be logical to assume, that “if a principle does not form part of the normal tax system in question, consequently there can be no derogation from it.” However, given the lack of harmonized rules on transfer pricing, it is controversial to imprint a principle of international tax law into the domestic legal system of a Member State and conclude that it necessarily forms part of the reference system against which the contest tax ruling will be measured against. Indeed, as Schön notes, the relevant

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123 FFT Final Decision, supra note 21, Recital 227.
124 Excess Profits Final Decision, supra note 29, Recital 134.
125 Apple Final Decision, supra note 23, Recital 253.
126 Ibid. 257.
benchmark cannot be derived autonomously from European Law...In order to protect the Member States prerogative in tax matters, the decisive benchmark for fiscal state aid can only be the tax legislation of the relevant country itself.”

The question is therefore, what is arm’s length principle that applies in the context of the application of Article 107(1) TFEU to tax rulings? Is there an EU Law arm’s length principle or can we regard the OECD arm’s length principle contained in Article 9 of the OECD Model Tax Convention as forming an inherent part of EU Law?

The Commission makes reference to the Forum 187 case as endorsement by the CJEU in using the arm’s length principle as a benchmark for establishing whether a group company receives an advantage for the purposes of Article 107(1) TFEU as a result of a tax measure that determines its transfer pricing and thus its taxable base. In that case, the Court stated “In order to decide whether a method of assessment of taxable income...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.” However, it is interesting to note that the Court made no explicit reference to the arm’s length principle or that the OECD profit allocation methods as necessarily forming part of EU law. Furthermore, this “endorsement” does not elaborate on what standard of the arm’s length principle it was supposedly endorsing. According to the Commission in FFT, it is not the arm’s length principle contained in the OECD Model Tax Convention but rather “is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the TFEU, which binds the Member States and from whose scope the national tax rules are not excluded.” An identical statement was included in the Excess Profits decision. It is curious that the Commission seeks to rely on the Forum 187 case as an endorsement for the arm’s length principle but then goes on to state that the arm’s length principle that it applies, is not that derived from the OECD Tax Convention. Despite not making an explicit reference to the arm’s length principle in the judgment, it does make explicit reference to the OECD Guidelines specifically in relation to profit allocation methods. Kyriazis notes “if the Court in the Forum 187 case was referring to a certain version of the arm’s length principle...then that was the arm’s length principle of the OECD.” In addition, the Commission clarified that it is also not examining whether the tax ruling complies with the arm’s length principle as laid down in the domestic law but whether the tax administration confers a selective advantage on an undertaking by issuing a tax ruling that endorses a profit allocation method that departs from the arm’s length principle. Thus, it is clear that the principle “takes on a Community dimension and is now firmly and explicitly anchored to EU primary law.”

130 FFT Final Decision, supra note 21, Recital 228.
131 Excess Profits Final Decision, supra note 29, Recital 150.
132 Kyriazis, supra note 78, 435
133 FFT Final Decision, supra note 21, Recital 229.
134 Moreno González, supra note 31, 563.
This communitarisation of the arm’s length principle would represent a radical development in the application of EU State aid rules in the area of direct taxation. Indeed, the 2016 Notice explicitly states that the arm’s length principle “necessarily forms part of the Commission’s assessment of tax measures granted to group companies under Article 107(1) TFEU.”\(^{135}\) This approach is less than satisfactory. While it may be the case, that the Commission wishes to avoid a situation where a fiscal aid measure falls outside the scope of State aid rules simply because that Member State says that an internationally recognized standard does not form part of its legal system or applies an arm’s length principle as laid out in domestic legislation that is more flexible, its approach seems rather dubious. Giving a community dimension to the arm’s length principle in the absence of harmonisation rules in the area of transfer pricing, risks uncertainty for tax administrations and companies alike in employing methods for determining a taxable base of an associated enterprise. What is the arm’s length principle to be applied? Will the OECD notion of arm’s length trading stand up to the scrutiny of the Commission in State aid cases? In that respect, taken to it most extreme, the Commission “could determine the existence of a selective advantage if it disagrees with the application by the Member States of the arm’s length principle in a specific case.”\(^{136}\) This in turn may have the consequence of an overly cautious tax administration resulting in the over-taxation of integrated companies.

4.2.2. The measure derogates from the reference system:

Now that it has been established that the Commission regards the reference framework as compromising of the general rules of corporate income taxation in the Member States concerned, the second step in the selectivity assessment is to establish whether the contested measure derogates from that framework. As previously mentioned, the approach taken by the Commission in the final decisions of FFT, Apple and Excess Profits, represents a departure from that previously seen in other cases such as the Commission’s much-cited Forum 187 case. From the outset, it is worth mentioning that the cases in focus in this paper represent two categories of cases. FFT and Apple both concern individual tax-rulings while Excess Profits concerns a tax-ruling scheme.

The Commission stated that the identification of the derogation coincides with the identification of an economic advantage. The approach emerges from the decisions can be summarised as follows. The Commission takes the departure from the arm’s length principle as its starting point. If it can be establish that the methodology used to determine the taxable base of the undertaking concerned, departs from the reference system of which the arm’s length principle forms a part; that methodology will be deemed to be out of line with the arm’s length principle. Subsequently, the Commission then looks at the margin of appreciation and ruling practice of the tax administration. Where the tax administration endorses this method as a true reflection of the taxable base of the associated enterprise, thus leading to a lowering in the burden of that undertaking’s corporate tax liability in the Member State concerned as compared to companies in a similar legal and factual situation; a selective

\(^{135}\) Commission Notice 2016, supra note 32, paragraph 172

\(^{136}\) Moreno González, supra note 31, 564.
advantage has been conferred. As can be seen from the examples provided below, the Commission’s focus in the second step of the selectivity test “does not rest so much on the identification of one or more various categories of companies benefitting [from] significant tax advantage over other entities...as on the way in which a standard or general principle is applied in a specific case.”

However, it is worth mentioning that in the Excess Profits decision, the Commission did follow a more traditional approach in establishing a selective advantage in establishing that the Excess Profit Exemption scheme derogated from the ordinary rules of corporate taxation in Belgium. The Commission considered that beneficiaries under the contested scheme were granted a selective advantage on the basis that it lead to a reduction in the taxable base of those undertakings in Belgium. It observed that the scheme was not available to all undertakings in a similar legal and factual situation and was therefore selective. Firstly, the excess profit exemption was only available to entities forming part of a multinational group in respect of cross-border operations. Thus it was not available to standalone enterprises or entities forming part of domestic corporate groups due to Article 185(2)(b) WIB 92 restricting the granting of an advance ruling, an essential requirement under the contested scheme, to entities engaged in cross-border transactions. This constituted a de jure selective treatment. Furthermore, an advance ruling could only be obtained in respect of new situations only. In addition, while not explicitly stated as conditions to benefit from the excess profit exemption, investments and/or the creation of employment or relocation of activities to Belgium were considered to be key elements in obtaining a ruling. Thus, the contested scheme resulted de jure selectivity between those multinational groups that establish new operations in Belgium and those multinationals that have existing operations in Belgium. Finally, the Commission considered that the synergies or economies of scale and other such benefits are the incentive to obtain a ruling in but these arise primarily in respect of entities belonging to sufficiently large multinational groups. Given the fact that the process for obtaining a ruling requires a detailed request outlining the new situation in terms of employment and the provision of a full excess profit study, this would be quite cumbersome for smaller corporate groups. The Commission therefore concluded that the excess profit exemption scheme was also de facto selective.

4.2.2.1. Departure from the arm’s length principle as a starting point:

This can be regarded as a critical in the establishment of a selective advantage. It represents a novel approach by the Commission in establishing the selectivity of a measure. Indeed, Gunn and Luts observe that two steps would ordinarily be needed to establish whether the contested rulings derogated from the normal system. The first would be “to identify the applicable domestic transfer pricing rules; the second to establish whether the APA results in a deviation from those rules.” They note that the Commission seems to ignore the first step and then assesses the existence of aid “by directly comparing the method of assessment established in

137 Ibid. 571.
138 Excess Profits Final Decision, supra note 29, Recitals 135-143.
139 Gunn & Luts, supra note 38, 122.
the APA with the arm’s length result obtained by applying the OECD Guidelines.”

Understandably in the case of Apple, there was no transfer pricing rules in place on which to make a comparison or even a transfer pricing report to accompany the contested rulings. In contrast however, the contested ruling in FFT was based on a transfer pricing legislation so it is curious that the Commission took this approach in that decision. Nonetheless, I will now seek to analyse this novel approach primarily by reference to the decisions themselves. In doing so, I will not refer to every line of reasoning used by the Commission but rather those aspects central to the discussion in this paper.

In each of the three decisions, the Commission considers that “where a tax ruling is based on a method of assessment that deviates from what would result from a normal application of the ordinary tax system without justification, that ruling will be considered to confer a selective advantage.” The Commission bases this on the CJEU ruling in the Forum 187 case in which they considered that where the method used to determine the taxable base departs from the arm’s length principle and thus results in a group company charging transfer prices that do not reflect those which would be charged in conditions of free competition. In FFT, Apple contests the methods employed by the tax advisors of those companies while in Excess Profits, the scheme itself prescribes the method to be applied in order to determine the portion of profits to be exempted.

In FFT, the Commission contested the use of hypothetical regulatory capital as a profit level indicator in the application of the TNMM in order to allocate profits to the Luxembourg based company. The Commission considered that the accounting equity would be a more suitable profit level indicator to arrive at a reliable approximation of a market-based outcome. The tax advisor determined risk remuneration by multiplying an estimated amount of capital by an estimated return on that capital. The Tax advisor estimates capital amount, by calculating FFT’s hypothetical regulatory capital using the Basel II framework. The estimated return on the capital is arrived at using the CAPM. However, regulatory capital is the minimum capitalization to be maintained by a bank or other financial institution and therefore does not constitute a portion of the profits of a regulated entity. The Commission is of the opinion that in order to achieve a market-based outcome, FFT’s tax advisor should have applied the return on equity it calculated using CAPM to FFT’s accounting profit. The consequence of not doing so was clear. The Commission observed that in 2011, FFT’s accounting profit was €287.5 million. However, under the method employed by FFT’s tax advisor the figure arrived at was just €28.5 million. It considered that the use of the Basel II framework in order to determine the company’s regulatory capital was inappropriate given it was not a regulated entity to which Basel II applies and so its use to estimate regulatory capital for tax purposes, makes it difficult to verify. Furthermore, the Commission noted in recital 263, that a return on regulatory capital is not commonly used as performance indicator in the financial sector. Therefore, averages of return on minimum regulatory are not

140 Ibid.
141 FFT Final Decision, supra note 21, Recital 219; Apple Final Decision, supra note 23, Recital 251; Excess Profits Final Decision, supra note 29, Recital 145.
142 FFT Final Decision, supra note 21, Recitals 249-266.
commonly analysed or available. Moreover, the Commission deemed the 66 comparables used by FFT’s tax advisor were inadequate given several of the selected companies were also not regulated entities under Basel II. The Commission concluded the use of regulatory capital as profit level indicator resulted in a lowering of FFT’s taxable base in Luxembourg leading to a lowering in it’s corporate income tax liability and thus gave rise to a selective advantage.

Furthermore, FFT’s tax advisor misapplied the Basel II framework to estimate the company’s hypothetical regulatory capital.\textsuperscript{[143]} The Commission noted that a proper application of the Basel II framework requires first, an estimation of FFT’s risk weighted assets (RWA) and then applying an appropriate regulatory capital ratio to that estimate. It found that FFT’s tax advisor underestimated both. In estimating FFT’s RWA, the tax advisor allocated a zero risk weighting to FFT intra-company loans to other Fiat Group entities while Fiat’s own Transfer Pricing Policy documents indicate a limited rather non-existent risk in relation to intra-group assets. Furthermore, the tax advisor allocated a 20% risk weighting to third party assets without any apparent basis. The Commission applied the average European risk weighting over assets of banks of 36% to FFT’s total assets of €14,827,674,000 and estimated that FFT’s hypothetical regulatory capital would have been €5,338,000,000. Then applying the 8% capital requirement ratio as stipulated under the Basel II framework, FFT’s hypothetical regulatory capital would be around €427 million. However, FFT’s tax advisor did not apply the required 8% ratio under Basel II but a ratio of 6%. In addition, the tax advisor’s calculation of FFT’s operating risk at 15% did not correspond to FFT’s gross annual income. The tax advisor applies that percentage to the net income stemming from bank deposits and loans only. Thus, all intra-group business was ignored for the purposes of calculating FFT’s gross income. The Commission concluded that the acceptance of Luxembourg’s tax administration of this confers a selective advantage on FFT in that it has the result of lowering the company’s tax burden as compared to non-integrated companies.

Similarly in Apple, the Commission did not consider the use of operating expenses as a profit level indicator to determine the taxable profit of ASI and AOE as resulting in a reliable market-based approximation in line with the arm’s length.\textsuperscript{[144]} In relation to ASI, the Commission found that use of operating expenses as a profit level indicator is generally associated with low-risk distributors. It did not regard ASI as a low risk distributor for numerous reasons. Firstly, ASI bears turnover risk that the Commission estimated to be as high as $67.5/68 billion in 2014. Due to the fact that ASI’s head office lacks a physical presence or employees, it regarded ASI’s Irish branch as bearing that risk. It noted that even though the Irish branch’s operating expenses remained stable over time, ASI’s sales increased significantly. Thus, bearing this correlation between sales and operating expenses in mind, the Irish tax administration should have called into question the appropriateness of using operating expenses as a profit level indicator. Secondly, ASI provides warranties for all goods sold throughout the EMEIA region. The Commission observed that these warranties represented significant liability in the transfer of assets and liabilities from ASI to Apple.

\textsuperscript{[143]} Ibid. Recitals 267-276.

\textsuperscript{[144]} Apple Final Decision, supra note 23, Recitals 334-345.
Distribution International (ADI). Once again, considering that ASI’s head office lacks any physical presence or employees it is unable to bear any of the product risk. The choice of operating expenses as the profit level indicator does not reflect the associated level of risk. Thirdly, ASI relies on third party contractors to ensure the distribution function. In recital 339 of the final decision, the Commission observed that the turnover generated by ASI stems in large part from goods handled that were never physically handled in Ireland itself. It asserted that the risk borne from the handling of these products would be better reflected in terms of sales than operating expenses. The Commission found that the choice of operating expenses as a profit level indicator instead of sales inappropriately lowers the annual taxable profit of ASI in Ireland. It noted that the resulting tax base “is very low and does not correctly reflect the risks assumed by that branch.”

In relation to AOE, it described its function as being responsible for the manufacture and assembly of a specialized range of computer products. The Commission remarked that AOE owns its inventories and appears to have control and bear the risk for at least part of the costs associated with those inventories. The Commission attributed this risk in full to AOE’s Irish branch. It considered in those circumstances, that a profit level indicator including total costs as being more appropriate than operating expenses for a manufacturing company such as AOE. Total costs represents a broader based than operating expenses, since operating expenses exclude costs relating to raw materials. The Commission concluded that the choice of operating expenses as a profit level indicator in respect of AOE resulted in an approximation that departed from the arm’s length principle and had the effect of reducing its taxable base and thus its corporate tax liability in Ireland.

The situation Excess Profits differs from FFT and Apple in that the contested scheme prescribed a method to determine the taxable profit of the Belgian group entity. In its decision the Commission contested the compatibility of this methodology with the arm’s length principle thereby having the effect of reducing the taxable base of the beneficiaries under the scheme and reducing those companies corporate tax liability to the Belgian State. Specifically, the Commission considered that under the second step of the process, as outlined earlier in this paper, the method used to determine the ‘adjusted arm’s length profit’ departs from the arm’s length principle. The Commission recalled that under the contested scheme, the Belgian entity is regarded as the central entrepreneur, in that it carries out the group’s most complex functions and is responsible for strategic and tactical decisions. Under the second step of the process, the ‘adjusted arm’s length profit’ was calculated using the same one-sided profit method used to determine the residual profit under the first step. Crucially however, the Belgian group entity was used as the tested party. According the OECD Guidelines, in the case where only one of the parties to a transaction makes a valuable and unique contribution or makes all the complex functions, the less complex party should be used as the tested party. The Commission considered that the residual profit arrived at under the first step should be considered the central entrepreneur’s arm’s length profit taking into

145 Ibid. Recital 341.
146 Excess Profits Final Decision, supra note 29, Recitals 144-168.
account its functions, the risks it bears and the assets it uses. Those portion of the profits deemed to be excess by Belgium are in fact a component of that residual profit. In recital 156, the Commission considered that the exempting any part of those profits from taxation constitutes an unjustified derogation from a market based outcome and is out of step with the arm’s length principle.

The Commission considered, contrary to Belgium’s argument that profits arising as a result of synergies or economies of scale should not be attributable to the Belgian group entity under the arm’s length profit; that the arm’s length principle does not support a general downward adjustment for profits arising as a result being part of a multinational group. Finally the Commission was of the opinion that the methodology resulted in the creation of an untaxed base that is in contravention of the arm’s length principle. The Commission concluded that the method under the second step of contested scheme resulted in an approximation that was not in line with a market-based outcome in that it leading to a reduction in the taxable base of the beneficiaries under the scheme and thus a lowering of those companies corporate tax liability in Belgium. It considered this to confer a selective advantage on those beneficiaries.

It is plainly clear that where the methodology departs from the Commission’s version of the arm’s length principle, a selective advantage will be found. However, the advantage that arises as a result of those methods cannot be realised without the endorsement of that methodology by the tax administration. In respect of individual tax rulings, the finding of a selective advantage necessarily depends on a finding that the ruling practice of a tax administration was flawed.

4.2.2.2. The margin of appreciation of tax administrations as determining factor:

At this point we must ask ourselves, what is the State liable for? The advantage that arises in tax ruling cases, is a reduction in the taxable base of the undertaking concerned leading to a reduction in the corporate tax it owes to the Member State as compared to companies in a similar legal and factual situation. Thus, we can conclude that the State is liable for forgoing revenue that is due to it. In the cases of FFT and Apple, the acceptance of the tax administration of methods used to allocate profits was attributable to a finding of a selection advantage. This aspect stems from the very nature of tax rulings themselves. The undertaking retains its freedom in selecting the method to allocate profits and thus determine a taxable base as per the OECD Guidelines. Therefore, it is the tax administration bears the burden in proving that that taxable base is prima facie inconsistent with a market-based outcome. Rossi-Maccanico observes “national authorities would typically have the power to allocate gross income, deductions, credits...whenever such allocations are appropriate in order to prevent avoidance of national taxes.”147 Any adjustment that is made will be done by comparing the uncontrolled transactions with similar uncontrolled transactions between independent enterprises and must thus be regarded as being consistent with the arm’s length

principle. Therefore “the corrective power of the tax administration is exercised with discretion.”148 Indeed, the ability of tax administrations to carry out their functions necessarily depends on a degree of flexibility as acknowledged by the Commission in the Apple decision.149 The decision to accept the methodologies as correct is an extension of this discretion. The converse is also true. The decision to accept the self-assessed profit allocation and the methodologies used to arrive at those figures is also an extension of that discretion. On the basis of the Commission’s approach to establishing a selective advantage, the competent authority is liable at the first stage, for a departure from the arm’s length principle in the approximation of the taxable base by a non-State actor and subsequently, for failing to recognize this departure and refraining from making an adjustment when endorsing the methodology insofar as that has the effect of lowering the burden of corporate tax liability for the undertaking concerned. This entails a presumption by the Commission that ‘but for’ the endorsement, the selective advantage does not arise. However, this is necessarily dependent on the correct interpretation of the arm’s length principle and the availability of comparables. Notwithstanding the fact that the Commission stated that the arm’s length principle is not that derived from the OECD Article 9 or the arm’s length principle laid out in national law, but rather a broad principle of equality under Article 107(1) TFEU. The problem with this is tax administrations are in no clear terms as to whether the profit allocation method they are endorsing is in line with this standard of the arm’s length principle. This is exemplified by the fact that the Commission took the same approach to proving the existence of a selective advantage in FFT as it did in Apple. The Commission stated in its Apple decision that rulings where discretion is exercised by the tax administration that is not based on objective criteria, give rise to a presumption of selective advantage.150 In response to Ireland’s assertion that the arm’s length principle did not govern the relevant provision, the Commission noted that it meant Revenue’s discretion in applying the provision was not based on objective criteria related to the tax system.151 The Commission also concluded that no objective criteria could be determined on the basis of Revenue Ruling practice alone. We can infer from this that if the tax administration can point to objective criteria that limited the exercise of its discretion, this could rebut the presumption that an individual aid measure is selective once an economic advantage has been established. It is the unilateral nature of the tax rulings in Apple that opens those rulings up to the scrutiny of the Commission. Any potential justification will thus be dependent on the tax administration being able to point to objective criteria that limit its discretion.

In contrast, Luxembourg did have transfer-pricing rules in place at the time of the contested ruling granted and explicitly embedded the arm’s length principle into its legislation. The Commission chose to ignore these rules as the benchmark to determine whether the tax ruling in question derogated from reference system but rather compared it directly with an-EU version of the arm’s length principle. In addition, there is no rule of European Union law that requires the adoption of a framework on which to adopt objective criteria.

148 Ibid. 374
149 Apple Final Decision, supra note 23, Recital 380.
150 Ibid. Recital 380.
151 Ibid. Recital 381.
Furthermore, the decision in *Apple* makes it clear that tax administrations have a positive duty to ensure that the profits allocated to a branch is the result of a reliable market-based approximation. In that decision, the Commission contested the acceptance by Revenue in Ireland of the unsubstantiated assumption that the Apple IP licences held by ASI and AOE should be allocated outside Ireland.¹⁵² Contrary to the claim made by Ireland, that Section 25 TCA 97 only allows it to tax that portion of profits arising in connection with those companies Irish branches; the Commission asserted in case of profit allocation between different parts of the same company, it is the company as a whole which holds the IP licenses. The Commission reasoned that since the Irish branches have no legal personality of their own, neither those branches or their respective head offices, could be said to separately own the assets or owe the liabilities of those companies. Therefore, it was incumbent on Irish Revenue to properly examine the assets used, the functions performed and the risks assumed by those companies through their Irish branches and through the other parts of those companies. This was because Section 25 TCA 97 necessitated the use of the arm’s length principle. This should serve as a strong signal to tax administrations, that in cases of unilateral tax rulings, it will have not only have to prove that it acted within the limits of its discretion but also that it took active steps to ensure that the profit allocation represents a reliable approximation of the taxable base for the undertaking concerned and if necessary, make the adjustments to that allocation where it suspects it is out of line with the arm’s length principle. Thus in an EU context, the power of the tax administration to make adjustments no longer solely corresponds to the avoidance of double taxation but that the adherence to the arm’s length principle is a necessary requirement for the purposes of displacing an allegation of illegal State Aid under Article 107(1) TFEU.

4.2.3. Justification on the basis of the nature or general scheme of the system:

The third and final step in establishing selectivity consists in assessing whether the selectivity of the measure can be justified on the basis of the general nature or scheme of the system. This was first mooted by the CJEU in *The Commission v. Italy*, where the Court stated that the partial reduction of social charges pertaining to family allowances favoured the particular industry “without there being any justification for this exemption on the basis of the nature or general scheme of this system.”¹⁵³ However, the Commission and the Courts have tended to give a narrow interpretation to the notion of justification and only certain justifications have been accepted. The justification is based on “the intrinsic features of the system concerned, or, in other words, on the basic or guiding principles of the identified tax system.”¹⁵⁴ In addition, any measure must be proportional to achieve the objective pursued by that system in that it must not go beyond what is necessary to achieve that aim. Furthermore, the burden of establishing the justification lies with the Member State at issue. In *FFT*, neither Luxembourg nor FFT put forward a justification for the selective treatment of FFT by way of the tax

¹⁵³ *Commission v. Italy*, supra note 2, paragraph 15.
ruling.\textsuperscript{155} In \textit{Apple}, Ireland itself did not advance any justification for the alleged selective treatment. Apple however, argued that the discretion exercised by Revenue is intrinsic to the Irish corporate tax system and that the rulings contributed to the effectiveness of the system and were proportionate.\textsuperscript{156} The Commission did not agree with this view holding that “the exercise of discretion by a tax administration, even if inherent in the application of certain fiscal rules, cannot in itself justify discrimination between taxpayers that find themselves in a similar factual and legal situation.”\textsuperscript{157} The inability of Apple and Ireland to any objective criteria means the only avenue of possible justification is closed.

In \textit{Excess Profits}, Belgium said that the measure was necessary to prevent potential double taxation.\textsuperscript{158} While the Commission acknowledged this as a possible justification, it found that Belgium could not demonstrate that the contested scheme actually serves that purpose. The Commission seems to take issue with the fact that the measure only concerns potential double taxation. This raises the interesting question of whether Member States should only grant a transfer pricing adjustment when there is a risk of cross-border double taxation.\textsuperscript{159} It suggests that in order to justify a tax ruling with the objective of avoiding double taxation it is necessary to show that the tax exempted is taxed somewhere. In \textit{Excess Profits}, Belgium could not do so but merely assumed that it is. This creates the risk of double non-taxation and thus negates the possible justification of avoiding double taxation. Indeed, the Commission found that the \textit{Excess Profits} exemption provides “a unilateral exemption granted in advance that does not require the exempted profit to have been or to be included in the tax base of an associated foreign group entity in another tax jurisdiction.”\textsuperscript{160} Furthermore, the Commission did not consider that the arm’s length principle to justify such a unilateral downward adjustment.

\textbf{4.3. Conclusion:}

In conclusion, the Commission’s approach to establishing the existence of a selective advantage could best be described as novel. In cases concerning tax rulings, the Commission will not restrict itself to a rigid application of the cumulative steps of Article 107(1) TFEU. Indeed, those steps must not act as a straight-jacket as State aid in the area of taxation general does not lend itself to an easy application of those rules. Indeed, in respect of tax rulings in particular, “the selectivity assessment becomes superfluous.”\textsuperscript{161} However, in some respects the Commission appears the stretch this flexibility in ways which raise more questions than answers. In the application of its three-step derogation test the Commission necessarily relies on the notion of what ought and less on what is. In identifying the relevant reference system, the Commission will adopt a broad framework comprising of the general rules on corporate income taxation in the Member State at issue. It will determine that such a system must have the taxation of all companies as its intrinsic objective. Furthermore, it will disregard national provisions which give different tax treatment to different categories of undertakings. In addition, the arm’s length necessarily forms part of this reference framework, independently

\textsuperscript{155} FFT Final Decision, supra note 21, Recital 337.
\textsuperscript{156} Apple Final Decision, supra note 23, Recital 405.
\textsuperscript{157} Ibid. Recital 407.
\textsuperscript{158} Excess Profits Final Decision, supra note 29, Recital 172.
\textsuperscript{159} R. Luja,’ Will the EU’s State Aid Regime Survive BEPS?’ [2015] B.T.R. 379, 386. [hereinafter Luja 2015].
\textsuperscript{160} Excess Profits Final Decision, supra note 29 Recital 174.
\textsuperscript{161} Rossi-Maccanico, supra note 147, 376.
of whether the Member State at issue has incorporated it into its legal system. The arm’s length principle the Commission applies has an EU law character and is a general principle of equality. Thus, the Commission’s approach necessarily involves in some respects a fictitious view of national law. For the purposes of identifying the reference framework, all companies subject to corporate income taxes in the Member State concerned are regarded as being in a similar legal and factual situation so the Commission will disregard the legal form and structure of the company in its assessment.

In relation to establishing that the contested ruling derogates from reference system, it is clear that the starting point will be the departure from the arm’s length principle. The focus then shifts to the margin of appreciation of the tax administration in endorsing a method that determines a taxable base that is out of line with a market-based outcome and thus leads to a reduction in the undertakings corporate tax liability in the Member State at issue. Finally, any justification must be based on the general nature or scheme of the system but this will be narrowly interpreted and will necessarily be limited to internal objectives of taxation such as the avoidance of double taxation.

The practical effect of the Commission’s findings in these cases may be the notification of every tax ruling to the Commission as both companies and tax administrations grapple with ensuring that a tax ruling is in line with Article 107(1) TFEU. The Commission has neither the resources nor the ability to analyse potentially thousands of tax rulings in detail.

5. Chapter Five: The future of tax rulings in a post-BEPS world

5.1. Introduction:

The question that remains is where does this leave the Member States with regard to tax rulings? The outcome of the Commission decisions in FFT, Apple and Excess Profits have caused surprise and angst in some circles, not least in the Member States involved but also a level of anger that fellow EU Member States have been “facilitating” the erosion of other Member States’ tax bases. Luxembourg, Ireland and Belgium have appealed the Commission decisions; which is hardly surprising given the reputational damage that has ensued. However, the outcome of those decisions makes a new milestone in the fight against harmful tax competition amongst EU Member States and aggressive tax planning by multinational enterprises. The decisions have accompanied a wide array of anti-avoidance measures. These measures aimed at increasing transparency of corporate income taxation within the EU. However, they have also had the effect of curtailing Member State’s margin of appreciation in relation to tax rulings.

5.2. The Appeals:

The Member States have signalled their intention to appeal the Commission’s findings. It may seem like a contradiction in terms; that a State should refuse funds owed to it. In the case of Apple, the €13 billion comes at a time when Ireland’s economy has only recently emerged from a near decade of austerity in the face of one of the worst banking crises in history. It is an astronomical amount of money to refuse. It might even be argued the Commission was acutely aware of this and may have sought to ride on a wave of internal political pressure.
However, we must bear in mind that the decisions tarnish the reputations of the Member States concerned and the integrity of the tax system. Where a Member State specifically uses its tax system as a tool to attract investment, reputation will be a key factor. It also places the government of the Member State between a rock and a hard place. Accepting the decision the of the Commission may send the wrong kind of signal to MNEs and may therefore threaten future investment and growth. The appeals will go to the General Court, where, Luja remarks “parties are not facing a level playing field.”\footnote{Luja 2015, supra note 159, 387.} He observes that the General Court will have “a hard task to work through all the technical issues involved in transfer pricing and to familiarise itself with its practical application.”\footnote{Ibid. 388.} The General Court tends to give a more restricted interpretation of EU State aid rules so it is likely that an appeal to CJEU is inevitable in any case. These are landmark cases and may be used as test cases to stretch the limits of Article 107(1) TFEU. Indeed, regardless of the outcome, the Commission has successfully heightened the need to fight against aggressive tax planning by multinationals and reduce the effects of harmful tax competition between EU Member States.

5.3. New Measures – tying the hands of the Member States?

The imposition of an arm’s length principle and the retroactive imposition of OECD Guidelines into the tax systems of the Member States severely curtails their margin of appreciation and means in effect, tax rulings will be governed by an EU standard. On a broader level, the decisions have been accompanied by a strengthening of measures at EU level. These include the adoption of Directive 2015/2376\footnote{Council Directive (EU) 2015/2376 of 8 December 2015 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation.} and Directive 2016/881\footnote{Council Directive (EU) 2016/881 of 25 May 2016 amending Directive 2011/16/EU as regards mandatory exchange of information in the field of taxation; [hereinafter Directive 2016/881].}. Both of these directives amend Directive 2011/16/EU. Article 9 of that Directive provides for the spontaneous exchange of information between Member State tax authorities in five circumstances, most noticeably, Article 9(a) where the competent authority in one Member States has grounds for supposing that there may be a loss of tax in another Member State and Article 9(d) where the competent authority has grounds for supposing that a saving of tax may result from artificial transfer of profits within groups of enterprises. The Commission investigations into tax rulings granted in Luxembourg, Ireland, Belgium and the Netherland; necessitated the need to strengthen the tools provided for in Directive 2011/16/EU.

5.3.1. The automatic exchange of information concerning cross-border tax rulings:

The first set of amendment relevant to the topic of this paper is Directive 2015/2376; which provides for the automatic exchange of information concerning cross-border tax rulings or advance pricing agreements, thus making the exchange of information concerning tax rulings mandatory. It is interesting to note that recital 13 of the directive makes explicit reference of the need to work closely with the OECD in a coordinated manner and the role the EU should play in promoting a global level playing field. Recital 14 makes it clear that the fact that a Member State has exchanged information regarding a tax ruling, such a ruling does not
escape the application of EU State aid rules in the absence of a notification by the Member State of its intention to grant aid. Interestingly, recital 15 states that “feedback by the receiving Member State to the Member State sending the information is a necessary element of the operation of an effective system of automatic information exchange.” This implies that Member States are not only accountable to the Commission but also to each other. Recital 19 provides for the establishment of a central directory that is accessible by all Member States and the Commission, thus increasing the transparency and ensuring that all Member State authorities obtain the same standard of information – any airing of dirty linen will be very public indeed.

Article 3 covers the scope of the Directive. Points 14 defines a advance cross-border ruling as “any agreement, communication, or any other instrument or action with similar effects, including one issued, amended or renewed in the context of a tax audit” that satisfies five conditions: (a) is issued, amended or renewed by, or on behalf of, the government or the tax authority of a Member State, or the Member State's territorial or administrative subdivisions, including local authorities; (b) is issued, amended or renewed, to a particular person or a group of persons, and upon which that person or a group of persons is entitled to rely; (c) concerns the interpretation or application of a legal or administrative provision concerning the administration or enforcement of national laws relating to taxes of the Member State; (d) relates to a cross-border transaction or to the question of whether or not activities carried on by a person in another jurisdiction create a permanent establishment; and (e) is made in advance of the transactions or of the activities in another jurisdiction potentially creating a permanent establishment or in advance of the filing of a tax return covering the period in which the transaction or series of transactions or activities took place. The cross-border transaction may involve, but is not restricted to, the making of investments, the provision of goods, services, finance or the use of tangible or intangible assets and does not have to directly involve the person receiving the advance cross-border ruling.

Point 15 of Article 3 defines an advance pricing agreement as “any agreement, communication or any other instrument or action with similar effects, including one issued, amended or renewed in the context of a tax audit” and which meets the following conditions: (a) is issued, amended or renewed by, or on behalf of, the government or the tax authority of one or more Member States, including any territorial or administrative subdivision thereof, including local authorities, irrespective of whether it is effectively used; (b) is issued, amended or renewed, to a particular person or a group of persons and upon which that person or a group of persons is entitled to rely; and (c) determines in advance of cross-border transactions between associated enterprises, an appropriate set of criteria for the determination of the transfer pricing for those transactions or determines the attribution of profits to a permanent establishment. Furthermore, it an enterprise is considered an associated enterprise where one enterprise participates directly or indirectly in the management, control or capital of another enterprise or the same persons participate directly or indirectly in the management, control or capital of the enterprises. Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises, and “transfer pricing” is to be construed accordingly. Note these definitions are
Article 8a of Directive 2015/2376 defines the scope and conditions concerning the automatic exchange of information between the Member State authorities. Article 8a (1) provides for the automatic exchange of information from the tax administration in one Member State with the tax administrations in all others regarding all cross-border rulings or advance pricing agreements issued, amended or renewed after 31st December. Furthermore, paragraph (2) of the same article requires the communication of all tax rulings issued, amended or renewed granted in the previous five years before January 1st 2017. Although this excludes groups, with the exception of those companies conducting mainly financial or investment activities, with a group wide turnover of less than €40 million per year. Paragraph (5) specifies that the information regarding a tax ruling granted should be exchanged within nine months of the end of the calendar year in which the ruling was issue, amended or renewed. Paragraph (6) specifies the information to communicated including; the amount of the transaction or series of transactions of the advance cross-border ruling or advance pricing arrangement; the description of the set of criteria used for the determination of the transfer pricing or the transfer price itself in the case of an advance pricing arrangement; the transfer pricing method used; the identification of the other Member States likely to be concerned by the advance cross-border ruling or advance pricing arrangement. Finally, paragraph 10 provides that Member States may “request additional information, including the full text of an advance cross-border ruling or an advance pricing arrangement.”

It is apparent that these measures have been designed to increase the transparency of tax rulings but also to increase the level of accountability among the Member States themselves. The requirement to exchange information concerning all tax rulings issued within the last five years as well as the opportunity for the tax administrations to give feedback and request information regarding a tax ruling issued in another Member State are quite a significant development. This opens up tax rulings to a greater level of scrutiny even retrospectively and increases the political pressure on Member States to ensure that tax arrangements with multinationals are consistent and apply on a consistent basis. Furthermore, it is clear that this consistency should be determined on the basis of a transfer pricing regime given the obligation on Member States to exchange details concerning the criteria used to determine a transfer price and the transfer-pricing used. The obligation to identify the other Member States that are likely to be affected by the advance ruling or APA seems rather onerous in that the scope of this obligation is not defined. When is a Member State likely to be affected? Is this based on the presence of an associated enterprise of the same group company that the reported tax ruling concerns or on the basis of some other criteria such as volume of sales. In the case of a multinational such as Apple, being a market leader in smartphones, laptops and online sales of music and with customers in every EU Member State, it would be likely that every Member State would be concerned.
5.3.2. **Country-by-Country Reporting Requirements:**

Directive 2016/881 implements the *OECD BEPS Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* recommendations into EU law. Country-by-Country Reporting (CbCR) involves MNE Groups providing annually and for each jurisdiction in which they do business the amount of revenue, profit before income tax and the income tax paid and accrued. A MNE would also report the number of employees, stated capital, accumulated earnings and tangible assets in each jurisdiction. In addition, the MNE Group identifies the each entity within the group doing business in a particular tax jurisdiction and provides an indication of the business activities in which each entity engages.\(^{166}\) Article 8aa amends Chapter II, Section II of Directive 2011/16/EU and provides for the scope and conditions for the mandatory automatic exchange of information of the CbCR. Article 8aa (1), provides that each Member State shall “require the Ultimate Parent Entity of an MNE Group that is resident for tax purposes in its territory, or any other Reporting Entity in accordance with Section II of Annex III, to file a country-by-country report with respect to its Reporting Fiscal Year within 12 months of the last day of the Reporting Fiscal Year of the MNE Group in accordance with Section II of Annex III.” However, this only applies to MNE Groups with a group wide turnover of more than €750 million per fiscal year. Furthermore paragraph (2) obliges the competent authority of the Member State where the CbCR was received to automatically exchange that report with any other Member States, on the basis of information provided by CbCR, one or more Constituent Entities of the MNE Group of the Reporting Entity are either resident for tax purposes or subject to tax with respect to the business carried out through a permanent establishment.

Article 8aa (3) sets out the information to be included in the CbCR. This includes aggregate information relating to the amount of revenue, profit (loss) before income tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees, and tangible assets other than cash or cash equivalents with regard to each jurisdiction in which the MNE Group operates; Furthermore, the MNE Group concerned must identify each Constituent Entity of the MNE Group setting out the jurisdiction of tax residence of that Constituent Entity and, where different from that jurisdiction of tax residence, the jurisdiction under the laws of which that Constituent Entity is organised, and the nature of the main business activity or activities of that Constituent Entity. According to Directive 2016/881/EU, it is incumbent on the competent authority to communicate the CbCR within 15 months of the last day of the Fiscal Year of the MNE Group to which the country-by-country report relates.

Directive 2016/811/EU attempts to somewhat safeguard an MNE Group from a re-adjustment in the corporate tax liability in a Member State from being carried out on the basis of the

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information contained in the CbCR. Article 16(6) is added and provides that information communicated between Member States shall be used only “for the purposes of assessing high-level transfer-pricing risks and other risks related to base erosion and profit shifting, including assessing the risk of non-compliance by members of the MNE Group with applicable transfer-pricing rules, and where appropriate for economic and statistical analysis.” It specifically prohibits an adjustment on the basis of the information in the CbCR but goes on to state that there is no such prohibition on using the information obtained “as a basis for making further enquiries into the MNE Group's transfer-pricing arrangements or into other tax matters in the course of a tax audit, and, as a result, appropriate adjustments to the taxable income of a Constituent Entity may be made.” While this goes some way in providing certainty to MNE Groups, it appears to be in some way a sword as well as a shield, by allowing the information to be used in an audit that subsequently leads to a re-adjustment. Whether this provides enough of an incentive for compliance by MNE Groups remains to be seen. In addition, Article 25a, obliges Member States to lay down rules on penalties in national law for infringements of the Directive. In Ireland, Section 891H (7) TCA 1997 provides that the penalty for failure to file a CbC Report or Equivalent CbC Report is €19,045 plus €2,535 for each day the failure continues. The penalty for filing an incomplete or incorrect CbC Report / Equivalent CbC Report is €19,045. In Luxembourg, Article 3(1) of the Law of 23 December 2016 on Country-by-Country reporting provides that failure to provide a report may incur a maximum fine of €250,000. In Belgium, the law dated 1st July 2016 and published in the Official Belgian Gazette on July 4th 2017, provides for penalties ranging from €1,250 to €25,000, as from the second infringement.

It is important to bear in mind that the Directives were adopted by the Council following a unanimous vote by the Member States. This aspect should not be underestimated. It constitutes a strong signal on behalf of the Member States that they are willing to participate with the Commission and the Parliament in combatting harmful tax competition within the EU and aggressive tax planning by Multinationals. For those Member States that were at the centre of the Commission investigations, perhaps this was an exercise in damage control and reputation restoration. No doubt cooperation on these initiatives may have been strongly influenced by the level of political pressure exerted on those Member States, both at home and abroad.

5.3.3. Proposed Commission amendment to the Accounting Directive:

An interesting development comes in the form of a proposal to amend Directive 2013/34/EU on Accounting [hereinafter the Accounting Directive]. The Commission proposal aims to strengthen transparency and public scrutiny regarding corporate income tax. Indeed, the

Commission explicitly states in the proposal that “public scrutiny can help to ensure that profits are effectively taxed where they are generated.”\(^{171}\) The proposal would require the parent company of the MNE Group to draw up a report publicly disclosing the income tax they pay and other relevant tax related information. Article 48b of the proposed amendment, provides that the reporting requirement would apply to MNE Groups with a worldwide turnover in excess of €750 million and which is governed by the law of a Member State. The medium to large subsidiary undertakings would also come under the scope of the amendment as per of Article 48b (2) where the parent company of such undertakings has a turnover in excess of €750 million and is not governed by the law of an EU Member State. The EU branches of non-EU companies would also be required to publically disclose income tax information on the basis of information of the parent company; where two conditions are met, namely where the company that opened the branch has a turnover exceeding €750 million and the ultimate parent company does not have a medium to large subsidiary in the Union. This would cover a situation similar to that of the Irish branches of ASI and AOE in Apple. In addition Article 48b, point 7, states that Member States shall require “subsidiaries or branches not subject to the provisions of paragraphs 3 and 4 to publish and make accessible the report on income tax information where such subsidiaries or branches have been established for the purpose of avoiding the reporting requirements set out in this Chapter.”

Article 48c of the proposed amendment covers the information to included in the report. This includes (1) a brief description of the nature of the activities; (2) the number of employees; (3) the amount of the net turnover (including the turnover with related parties); (4) profit or loss before income tax; (5) income tax accrued (current year); (6) income tax paid and (7) accumulated earnings.\(^ {172}\) Moreover, the undertaking concerned would be required to publish information referred to above in respect of each Member State and separately for each tax jurisdiction. The information attributed to each tax jurisdiction “on the basis of the existence of a fixed place of business or of a permanent business activity which, arising from the activities of the group, can give rise to income tax liability in that tax jurisdiction.”\(^ {173}\) Article 48f of the proposed amendment requires Member States to ensure that where the financial statements of the undertakings are audited, this audit should also check whether the report on income tax has been provided and made available and should be indicated as such in the audit report.

The Commission proposes to adopt the amendment using Article 50(1) TFEU as its legislative basis since it amends an existing directive which itself is based on that Article. It justifies this on the basis of the principles of subsidiarity and proportionality. The principle of subsidiarity is defined in Article 5(3) of the Treaty of the European Union [hereinafter TEU]. The principle dictates that the EU should not take action (except in the areas that fall within its exclusive competence), unless it is more effective than action taken at national, regional or local level. The Commission in its proposal says the subsidiarity principle is satisfied due to

\(^{171}\) Ibid. section 1.


the aggressive planning and tax base erosion by multinationals. The principle of proportionality is found in Article 5(4) TEU and requires that any action by the EU should not go beyond what is necessary to achieve the objectives of the Treaties. The Commission says the proposal does not go beyond what is necessary to achieve the objective of transparency. This can best be regarded as a strategic move by the Commission, comfortable in the knowledge that such a proposal would fail to achieve unanimity if adopted on the basis of Article of 115 TFEU which empowers the Council to “issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market” i.e. a vote to transfer powers on direct taxation to the Union. Seer and Wilms questions the legislative basis on which the Commission seeks to adopt the proposal and whether the “purpose of the proposed amendment to the Accounting Directive has an at least substantial purpose to harmonize tax provisions which ensure tax compliance...”\footnote{Seer & Wilms, supra note 172, 332.} Furthermore, they remark that despite the overlapping requirements of the proposal and the CbCR requirements under Directive 2016/811/EU, a major difference between that directive and the proposed amendment to the Accounting Directive, is the “information which [has] to be kept secret in the sphere of tax administrations become suddenly transparent.”\footnote{Ibid.}

This certainly represents a radical proposal and will prove deeply unpopular with some Member States in particular. It may give rise to allegations that the Commission is attempting to harmonise tax laws within the EU under the cloak of accounting principles. The proposal places public scrutiny at its heart and seeks to use that scrutiny to “shame” multinational enterprises into abandoning aggressive tax planning. It may also have the effect of shaming Member States into ensuring corporate income taxation rules comply with the OECD standards and BEPS as any tax ruling granted is also in the eye of the ordinary European citizens. Member States will not only be accountable to the Commission and to each other but also to their own citizens and citizens across the Union. The idea is admirable and the underlying logic seems good. However, it does appear to usurp the control of corporate taxation in the EU out of the hands of the Member States and will prove to be quite controversial.

**5.4. Conclusion:**

The amendments to Directive 2011/16/EU with regards to the automatic exchange of information concerning cross-border tax rulings and the CbCR requirements go a long way in restraining the role played by national tax administrations in the granting of tax rulings. They seek to increase the level of transparency; which can only be a good thing and is certainly necessary in light of the global and indeed European fight against tax evasion. However, they also seek to increase accountability. This accountability not only is directed at the multinational enterprises that take advantage of the EU’s dysfunctional relationship with corporate taxation but also national tax administrations. They signal the beginning on an era where the tax administration in one Member State is directly accountable in respect of a tax
ruling, to the tax administrations of all other Member States. Their conduct will be scrutinized and judged against a European standard. This will no doubt increase the political pressure on Member States to ensure compliance with corporate tax rules and may go some way in putting an end to “sweetheart dealing.” The cumulative effect of these measures on tax rulings is one of restraint and visibility. The Commission proposal to amend the Accounting Directive is radical and unprecedented and could lead to a head on collision with the Member States themselves. In an era where some in the Union have questioned their place in the Community; it is a dangerous game to play and will beef up the Eurosceptic argument that the Commission, as an unelected and undemocratic body, is robbing the Member States of their sovereignty and identities.

**General Conclusion:**

“State Aid is not a cure for all ills.”

- Neelie Kroes -

I began this paper with a quote and so I shall finish with one. These are the words of Neelie Kroes, former European Commissioner of Competition writing in the Guardian newspaper on 1st of September 2016.176 The Commission decisions in *FFT, Apple* and *Excess Profits* mark a new era in the application of State aid rules to taxation. Unapologetic and undeterred by allegations of encroachment on national sovereignty; the Commission has sent out a strong signal that all companies, big and small, will have to pay their fair share in the EU even if that means stretching the limits of Article 107(1) TFEU. The novel approach utilised by the Commission has set a new precedent in the determination of whether a tax ruling constitutes illegal state aid. It is clear the Commission is not willing to restrict itself to a formalistic approach to satisfying the requirements of Article 107(1) TFEU. At the centre of its analysis lies the arm’s length principle. It will apply a strict standard of the principle and can be regarded as having an EU law character. Thus, even where a Member State has not implemented the ALP into national law, the Commission necessarily regards it as forming an essential part of the reference framework. This is quite a controversial and in some respects disconcerting. Furthermore, the relationship between the application of EU State aid rules is not entirely clear. The Commission regards them as the international standard but appears to apply a stricter standard of arm’s length principle. On one hand, we can say that the Commission retroactively applies the OECD Guidelines to transactions that have taken place in the past, while on the other developing its own equality based arm’s length principle. This will lead to great uncertainty for both businesses and tax administrations alike. Furthermore, the endorsement of the departure from the arm’s length principle by the relevant tax administration is a decisive factor in determining whether a contested ruling gives rise to a selective advantage. That advantage being a reduction in the taxable base of the undertaking

concerned thus leading to lower corporate tax liability in the Member State at issue. Therefore, the margin of discretion exercised by the tax authority and whether that is limited by objective criteria will be critical in establishing a selective advantage in terms of tax rulings.

Going forward, it is clear that the decision reached by the Commission in FFT, Apple and Excess Profits is in line with its agenda to fight to aggressive tax planning by multinationals and harmful tax competition among EU Member States. The measures will go a long way in increasing the transparency of tax rulings and the accountability to the Member States that grant them, a much needed and welcome development. The measure do in some ways however, have the effect of tying the hands of the Member States in relation to the granting of tax rulings. Tax rulings will be scrutinised not only by the Commission but also by fellow Member States. The margin of appreciation exercised by the granting tax authority is thus significantly more limited. While the mandatory automatic exchange of information concerning tax rulings and the recently introduced Country-by-Country requirements can be regarded as developments in line with the direction the Commission has taken in relation to tax avoidance, it is questionable whether the proposed amendment to the Accounting Directive pursues an objective that goes beyond its anti-avoidance character and is more in tune with the Commission’s plan to develop the Common Consolidated Corporate Tax Base (CCCTB). Furthermore, the public disclosure of information protected under CbCR seems to be a step too far and could backfire on the Commission.

I set out to determine the compatibility of tax rulings granted by Member States with State aid rules. The short answer to question to my question is, yes. Tax rulings are indeed compatible with EU State aid rules but the limits to that compatibility are easily reached. However, the question remains whether State aid is an appropriate forum to correct the inequalities that arise in relation to taxation. As long as the Member States retain the exclusive competence in direct taxation matters, EU State aid rules will continue to be stretched and squeezed by the inherent tensions that exist in EU law in the area of tax rulings.
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