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Is the Commission's Arm's Length Principle Compatible with the Principle of Legal Certainty?

by

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Summary

The European Commission's Decisions addressing tax rulings which came into the public domain in November 2014 as constituting State Aid (contrary to Article 107 TFUE) after Lux-Leaks have generated some discussion. Of paramount interest in this thesis is the Commission's declaration in the Belgium Excess Profits, Fiat and Starbucks Decisions that the European Union has its own ALP (hereinafter called EC-ALP).

In the quest to determine the compatibility of this statement with the principle of legal certainty and legitimate expectations, a key finding from case law is that the CJEU will usually balance the private interest of Member States and the public interest of the EC to determine which one overrides the other and invariably whether a breach has been occasioned.

It is recommended that though it constitutes an advancement of European Union fiscal State Aid law for the Commission to have its own standard of assessment which is reliable, it may be better to consider refining the OECD-ALP.

Should the EC seek to apply the EU-ALP, there must be present a cross-border situation as well as a comparable situation in the State Aid cases to which it seeks to apply the standard.

Abbreviation list

AG	Advocate General
ALP	Arm's Length Principle
APA	Advanced Pricing Arrangements
BEPS	Base Erosion and Profit Shifting
CJEU	Court of Justice of the European Union
EC	European Commission
ECJ	European Court of Justice
EU	European Union
MNE	Multinational enterprise
OECD	Organisation for Economic Cooperation and Development
PSM	Profit Split Method
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

1 Introduction

The Single Market is a bedrock of the European Union (EU/Community). It enables people, services, goods and capital to move freely within the 28-nation group. In practice, the single market provides a fair and open playing field for businesses, large and small, to compete. The Single Market gives consumers a wider choice of goods and services at competitive prices. To create this Single Market, numerous technical, legal and administrative barriers to free trade between EU Member States have been abolished.¹

The European Commission (EC) is committed to unleashing the full potential of Single Market. Together with the Court of Justice of the European Union (CJEU), the EC ensures that Member States comply with Single Market legislation. When needed, the EC can propose new legislation to tackle emerging barriers to free trade in the EU. However, the Single Market is undermined by barriers in areas where integration in the EU is lagging. For example, the fragmented national tax systems in the EU have contributed to situations where Member States have designed tax systems that grant selective tax advantages to some Multi National Enterprises (MNEs).² Such selective support by public authorities constitute State aid,³ which though can be justified, is generally prohibited in Article 107 of the Treaty on the Functioning of the European Union (TFEU).

In line with its mandate, the EC ensures that State Aid legislation is respected and exemptions are applied equally across the EU. The EC has applied the OECD arm's length principle (OECD-ALP) in previous cases as a measure of equal treatment of businesses. The EC has since 2001 investigated national tax schemes that seem to allow MNEs to price intra-group transactions in a manner that does not reflect pricing of similar transactions between independent businesses at arm's length.⁴ The CJEU has also applied the OECD-ALP in judgements on profit allocation, interest deductibility and State Aid cases. The OECD-ALP is thus accepted as the standard by which

¹ European Commission, 'The EU Explained: Internal Market' (European Union 2014). https://europa.eu/european-union/topics/single-market_en accessed 20 May 2017.

² Commission Decision of 11.06.2014 in Case SA .38373 Ireland Alleged aid to Apple; Commission Decision of 21.10.2015 On State Aid SA.38375 which Luxembourg granted to Fiat; Commission Decision of 21.10.2015 On State Aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks; Commission Decision of 07.10.2014 in the Case SA.38944 Luxembourg Alleged aid to Amazon.

³ 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/C 262/01)

⁴ Commission Decision of 22.08.2002 in Case C 48/2001 (ex NN 43/2000) on the aid scheme implemented by Spain in favour of coordination centres in Vizcaya, OJ L 31, 6.2.2003, p.26;

MNE profit can be measured and assessed. What may be a cause for concern is what some jurists have described as the EC's postulation of its own ALP⁵, and the extent to which this EC-ALP is compatible with the principle of legal certainty.

1.1 Aim

According to the EC, the 'EC ALP' is a general expression of the principle of equal treatment. Wattel⁶ brings to the fore the issue that the EC's pronouncement that there is an 'EC ALP' is likely to constitute a breach of the principle of certainty. Lyal⁷ also highlights how tax rulings should be treated from the State Aid perspective. This thesis aims to assess whether the EC's declaration and application of its own 'ALP' is compatible with the principle of legal certainty. In addition, the thesis seeks to assess some issues that may arise in applying the principle of equal treatment in the assessment of the State Aid/ Transfer Pricing cases.

1.2 Method and material

The thesis employs the legal dogmatic approach and normative perspective of research. By the legal dogmatic approach, the author delves into the recent EC postulation of an EU-ALP. In this approach, the author begins with a literature review of EU State Aid and the use of tax rulings as well as how the EU has treated the OECD-ALP. This reveals that the EC has in recent times had its reservations about the ALP. By this approach, the author explores the extent to which the EC ALP may conflict with the general principle of legal certainty by the application of case law and arguments from authoritative texts, with the aim of presenting the law as a coherent system. With this aim in mind the author gleans principles from the EU Courts on which basis the conclusions are drawn.

The normative perspective is employed to make deductions and recommendations as to a possible approach the EC may adopt in developing its own standard. In adopting this approach, the author observes how the EC itself has in other legislative matters introduced guidelines and rules. The methods adopted in those instances have been used as basis to propose how the issue in this thesis may be tackled. In addition, efforts adopted by an international body have been recommended for possible reforms. The author has compiled and analysed the materials as of

⁵ Peter J. Wattel, 'Stateless Income, State Aid And The (Which?) Arm's Length Principle' (2016) 44 Intertax.

⁶ Wattel (n 10).

⁷ Richard Lyal, 'Transfer Pricing Rules and State Aid' (2015) 38 Fordham International Law Journal.

1.3 Delimitation

The postulation of the EC ALP is unprecedented because in previous cases the EC has accepted the OECD-ALP in Decisions pertaining to MNE profit allocation. The CJEU, in its judicial review role, is yet to speak to its compatibility with EU law. Materials available on this subject are limited to writings of jurists. There are also a limited number of cases in which the principle of legal certainty is applied to illegal fiscal aid matters. Despite this, the author gleans principles from tax and non-tax cases on the principle of legal certainty to answer the questions. Generally, the discussion in this thesis relies on inter alia, the Treaties, the general principles of EU law, case law, Commission Decisions and Notices and publications by jurists. The principle of equal treatment and non-discrimination are used interchangeably.

2 Background

2.1 State Aid and Tax Rulings

State Aid prohibited in Article 107 TFEU has been held to apply in the domain of taxation. This is trite knowledge, gathered from the very beginnings of the jurisprudence of the CJEU.⁸ State Aid exists whenever the financial situation of an undertaking is made better because of State intervention. Invariably, whenever the financial position of the entity is improved on terms different from normal market conditions, there is a selective advantage. This may be through advantages and relief or waiver of economic burdens.⁹ To determine this, the financial situation ante must be compared the status quo post intervention.¹⁰

On June 11, 2014, the EC initiated State aid proceedings against three Member States in respect of advance tax rulings granted in relation to the transfer pricing practices of certain multinational groups (Ireland Apple;¹¹ Luxembourg Fiat;¹² and the Netherlands Starbucks¹³). It adopted a fourth decision in the same series on October 7, 2014 (Luxembourg Amazon¹⁴). On the 11th of January 2016, yet another Decision (Belgium Excess profits¹⁵) has heightened sensitivity and attention to the manner in MNEs arrange their affairs and a widespread public perception that they do not pay their "fair share of tax".

State Aid rules prevent the tax authorities of a state from granting a more lenient treatment to a taxpayer. Member States through tax rulings, also known as APAs, provide legal certainty to the undertakings concerned on the tax treatment of transactions between companies which are members of the same corporate group or in some cases between establishments of a single company in different countries. A tax ruling is a procedure which determines ahead of time the application of the national tax system to a case in view of

⁸ Case C- 30/59 De Gezamenlijke Steenkolenmijnen in Limburg v High Authority of the European Coal and Steel Community. ECLI:EU:C: 1961:2 p. 20

⁹ Case C-280/00 Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH, and Oberbundesanwalt beim Bundesverwaltungsgericht ECLI:EU:C:2003:415 para 84

¹⁰ European Commission, '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) C 262/01 Official Journal of the European Union.

¹¹ Commission (n 2)

¹² Commission (n 2)

¹³ Commission (n 2)

¹⁴ Commission (n 2)

¹⁵ Commission (n 2)

its specific facts and circumstances.¹⁶ An advantageous ruling is not necessarily selective.¹⁷ Tax rulings confer a selective advantage on their addressees only where:

- a) the ruling misapplies national tax law and this results in a lower amount of tax¹⁸
- b) the ruling is not available to undertakings in a similar legal and factual situation¹⁹
- c) the administration applies a more 'favourable' tax treatment compared with other taxpayers in a similar factual and legal situation

The third point above could, for instance, be the case where the tax authority accepts a transfer pricing arrangement which is not at arm's length because the methodology endorsed by that ruling produces an outcome that departs from a reliable approximation of a market-based outcome.²⁰ The latter case is the focal point of discussion in this thesis.

2.2 Transfer Pricing & Advanced Pricing Arrangements

The taxable profit of a company is its total revenue from sales and other income less the cost of obtaining that income. Costs include what is to be paid for goods and services purchased. Where a company buys goods or services from an independent seller, or borrows money from a bank, it is easily accepted as a reflection of reality of the expense. On the profit side also, where goods or services are supplied to an unrelated purchaser, there is an expectation that the seller will make profit. However, where transactions take place between related companies²¹ (companies under common control), the price of transactions can be manipulated to allow the group to lower its taxes, by shifting revenue to low-tax countries, and over-stating costs in high-tax countries. These are transfer prices and the standard used to correct the pricing is known as ALP as in Article 9(1) of the OECD Model Tax Convention on Income and on Capital.

¹⁶ Commission (n 10) [169] – [174]

¹⁷ Raymond Luja, 'State Aid Benchmarking And Tax Rulings: Can We Keep It Simple?', *State Aid Law and Business Taxation* (1st edn, Springer Berlin Heidelberg 2017) Section 3.2.

¹⁸ Commission Decision 2003/601/EC of 17 February 2003 on the Foreign Income aid scheme implemented by Ireland (OJ L 204, 13.8.2003, p. 51), recitals 33 to 35

¹⁹ Commission Decision 2004/77/EC of 24 June 2003 on the tax ruling system for US foreign sales corporations (OJ L 23, 28.1.2004, p. 14), recitals 56 to 62

²⁰ Commission (n 2)

²¹ The author uses this term interchangeably with MNEs

In the context of the EU, the tax authorities issue APAs approving or disapproving the prices set by the MNEs depending on their appropriate application of the ALP and the methods²² prescribed in the OECD Guidelines.²³ There are instances where the tax authorities confer some advantages onto the MNEs through the APAs issued which can constitute State Aid. These APAs have become subject to the Commission review, as can be seen in the cases below.

2.2.1 Review of Advanced Pricing Arrangements

The fight against tax evasion and tax fraud has been stated to be one of the top priorities of the Commission. The Commission has been investigating the tax ruling practices of Member States since June 2013. It extended this information inquiry to all Member States in December 2014.²⁴ In the process, it has raised concerns that tax rulings may give rise to state aid issues.

In the Apple,²⁵ Amazon,²⁶ Fiat²⁷ and Starbucks Decisions,²⁸ the OECD-ALP was used as the standard for determining whether intra and inter group pricing provides a selective advantage.

According to the EC:

The OECD Guidelines are a reference document recommending methods for approximating an arm's length pricing outcome and have been retained as appropriate guidance for this purpose in previous Commission decisions. (...) It is in the light of these general observations that the Commission will examine whether the contested rulings comply with the arm's length principle.²⁹

However, the EC had a different outlook from the above in the Belgian Excess Profit case³⁰ which can have certain implications for EU law.

²² The OECD Transfer Pricing Guidelines provide five methods to approximate an arm's length pricing of transactions and profit allocation between companies of the same corporate group: (i) the comparable uncontrolled price method; (ii) the cost-plus method; (iii) the resale minus method; (iv) the TNMM and (v) the transactional profit split method.

²³ Commission (n 16) Section 5.4.4.1

²⁴ European Commission Press Release "Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules; http://europa.eu/rapid/press-release_IP-15-5880_en.htm

²⁵ Commission (n 2).

²⁶ Commission (n 2).

²⁷ Commission (n 2).

²⁸ Commission (n 2).

²⁹ Commission (n 2).

³⁰ Commission Decision of the 11th of January 2016 in the Case SA.37667 Belgian Excess Profit Exemption State Aid Scheme.

The EC, by letter of 19 December 2013, commenced proceedings against Belgium on its so-called 'Excess Profit Exemption Scheme'. The scheme allowed Belgian resident companies that are part of an MNE and Belgian permanent establishments of foreign resident companies that are part of an MNE (hereinafter called "Belgian group entities") to reduce their tax base in Belgium by deducting from their recorded profit otherwise known as "excess profit". Excess profit results from deducting a hypothetical average profit that a standalone company carrying out comparable activities could be expected to make in comparable circumstances from the profit recorded by the Belgian group entity in question. The effect is a reduction in the taxable profit of the MNE. An advance ruling would ordinarily be issued by a special ruling commission, to benefit from the excess profit exemption. As a justification, the said excess profit exemption was to ensure that a Belgian group entity was only taxed on its arm's length profit by exempting from taxation the profit recorded more than its arm's length profit. This profit, they claim, is in line with "synergies, economies of scale or other benefits" drawn from its association with the MNE which would not exist for a comparable standalone company.

The scheme reduced the corporate tax base of the Belgian group entities by between 50% and 90% to discount for so-called "excess profits".³¹ The EC's in-depth investigation showed that by discounting "excess profit" from a company's actual tax base, the scheme derogated both from:

- a) Normal practice under Belgian company tax rules
- b) The ALP under EU state aid rules

The first because it gave MNEs who could obtain such a tax ruling a preferential, selective reduction compared with other companies. About 35 companies were granted a tax advantages over their stand-alone competitors, which are liable to pay taxes on their profits recorded in Belgium.

The second because even if an MNE generates such "excess profits", under the ALP they would be shared between group companies in a way that reflects economic reality, and then taxed where they arise. However, under the Belgian "excess profit" scheme such profits are simply discounted unilaterally from the tax base of an undertaking in the same MNE.

The most interesting part of the Belgian Decision, for this paper, is the EC's emphasis that its autonomous EU-ALP is not derived from the OECD Guidelines:

³¹ European Commission, 'State Aid: Commission Concludes Belgian "Excess Profit" Tax Scheme Illegal; Around €700 Million To Be Recovered From 35 Multinational Companies' (2016) <http://europa.eu/rapid/press-release_IP-16-42_en.htm> accessed 1 June 2017.

The arm's length principle therefore necessarily forms part of the Commission's assessment under Article 107(1) of the Treaty of tax measures granted to group companies, independently of whether a Member State has incorporated this principle into its national legal system and in what form. It is used to establish whether the taxable profit of a group company for corporate income tax purposes has been determined based on a methodology that approximates market conditions, so that that company is not treated favourably under the ordinary corporate income tax system as compared to standalone companies whose taxable profit is determined by the market. Thus, for any avoidance of doubt, the arm's length principle that the Commission applies in its State aid assessment *is not that derived from Article 9 of the OECD Model Tax Convention and the OECD TP Guidelines*, which are non-binding instruments, but a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty, which binds the Member States and from whose scope the national tax rules are not excluded.

2.3 The Arm's Length Principle & EU law.

The ALP is a standard used to price transactions within MNEs for purposes of determining corporate income tax payments in the home and host countries where the MNE operates. The ALP requires that transfer pricing be based on the prices that unrelated parties would negotiate if they were engaged in similar transactions under the equivalent circumstances as the MNE transactions³². The principle dates to 1935 when Section 45-1(b) of the US Treasury Corporate Income Tax Regulations was published, defining the standard to be used by the IRS Commissioner in allocating corporate income tax among related parties as:

“The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.” It is said to be “a resilient mainstay of the

³² OECD Model Tax Convention on Income and on Capital, OECD (2014) Art 9; L. Eden, “Taxes, Transfer Pricing and the Multinational Enterprise,” in Alan Rugman (ed.) *Oxford Handbook of International Business* (2nd edn. Oxford: Oxford University Press 2009) pp. 591–621.

framework within which perceived distortions of the allocation of multinational or global corporate group income are addressed”.³³

The earliest evidence of the recognition of the ALP in EU taxation is in Lankhorst-Hohorst,³⁴ SGI³⁵ and Test Claimants in the Thin Cap Litigation Group³⁶ cases.

In the Thin Cap case, the CJEU’s (then referred to as ECJ) Grand Chamber gave prominence to ALP as a determinant of the extent to which a domestic thin cap rule restricting the freedom of establishment for purposes of combating tax avoidance practices is proportional to the objectives sought. The CJEU held that such measure is incompatible with the proportionality principle if its scope is not restricted to arrangements which are wholly artificial. A provision applicable to any interest due on any and every loan provided by a group entity residing in another Member State is therefore disproportional. However, if the taxpayer does not provide cogent evidence to that effect, the thin cap rule will not constitute a restriction on the deductibility of an arm’s length interest.

Even before such recognition by the CJEU, the EC, Council and Member States also explicitly recognized the ALP as a fair profit allocation principle that could facilitate cross-border economic activity within the internal market.³⁷ In that vein, Member States had and still have the power to determine whether the allocated interest due by a resident corporate taxpayer would be, in whole or in part, tax deductible, subject to the requirements of primary EU law. The advent of Thin Cap has, in addition to profit allocation, resulted in ALP being viewed as a profit determination principle. Therefore, where a Member State has adopted an interest limitation rule which restricts a Treaty freedom (such as free movement of capital) but is justified for purposes of combating tax avoidance, such rule cannot restrict the deductibility of more interest than an arm’s length interest.

Also in the Forum 187 case, the Belgian Government and/or Forum 187, argued that the Belgian tax administration was bound by the OECD transfer pricing guidelines as a proper standard for reference in their defence. The CJEU indicated that EU Member States should apply the ALP as embedded

³³ J. Scott Wilkie, 'Reflecting on the “Arm’s Length Principle”': What Is The “Principle”? Where Next?', *Fundamentals of International Transfer Pricing in Law and Economics* (1st edn, Springer Berlin Heidelberg 2012) P141.

³⁴Case C-524/04 Lankhorst-Hohorst ECLI:EU:C: 2007:161

³⁵ Case C-311/08 SGI ECLI:EU:C: 2010:26

³⁶ Case C-524/04 Test Claimants in the Thin Cap Litigation Group ECLI:EU:C: 2007:161

³⁷ Pieter van Os, 'Interest Limitation Under the Adopted Anti-Tax Avoidance Directive and Proportionality' (2017) 25 EC Tax Review.

in their national tax system to resemble prices that would have been charged “in conditions of free competition”. In that case a cost-plus method was used where certain highly relevant costs were excluded from the cost-plus base.³⁸

Within the EU, ALP is applied in Article 4 of the EU Arbitration Convention (1990)³⁹ and in Member States’ transfer pricing guidelines. The EC also, in its 2001 report ‘Company Taxation in the Internal Market’, recognized that the ALP as a core component of transfer pricing, representing a coherent and sound concept for establishing the correct attribution of company profits between countries’.⁴⁰ However, the conclusion has been that the ALP is becoming increasingly difficult to apply, and transfer pricing rules and practices among Member States differ significantly.

³⁸CJEU Joined Cases C-182/03 and C-217/03 of 22 June 2006, *Belgium and Forum 187 v Commission*, ECLI:EU:C:2005:266, para. 96.

³⁹ Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, [1990] OJ 1990 L 22590/463/EEC/10.

⁴⁰ Commission, “Company Taxation in the Internal Market” (Commission Staff Working Paper) COM (2001)582 final p. 255

3 Compatibility of EC ALP with the Principle of Legal Certainty

3.1 Powers of the European Commission

The EC is one of the main institutions of the EU representing the general interest of the Union. The powers of the EC may be grouped into legislative, administrative, executive and judicial functions.

The EC's legislative role as the sole initiator of new legislation places it at the forefront of policy development. In its administrative mandate, the EC supervises national agencies to ensure enforcement of legislation.⁴¹

This paper focuses on the judicial role of the EC. The EC performs two key judicial functions:

- a) ensuring the application of the Treaties and the law that flows therefrom
- b) overseeing the application of Union law under the control of the CJEU

In the latter role, the EC serves as the investigator and initial judge of certain Treaty violations by legal entities or by Member States particularly in competition policy and state aids. The Decisions addressed by the EC are subject to review by the General Court.⁴²

3.2 The Normative Composition of the European Union

3.2.1 Sources and Hierarchy of Union Law

The EU legal order can be divided into primary legislation (the Treaties and general legal principles) and secondary legislation (based on the Treaties). The legal order may be arranged in five principal tiers as the hierarchy of norms in EU law.⁴³ These are Treaties and Charter of Fundamental Rights, General Principles of Union law, Legislative Acts, Delegated Acts and Implementing Acts.

The Treaties (Treaty of the European Union, TEU and TFEU) are at the top of the hierarchy. The Charter of Fundamental Rights also has the same value as the Treaties.⁴⁴ It is important here to note that any legislative act must be

⁴¹ Article 17(1) TFEU

⁴² Article 17(1) TEU Craig P., *Burca EU Law Texts, Cases, Materials* (Oxford University Press 2008) 39

⁴³ B.J.M. Terra & J. Kajus, *Introduction to European VAT (Recast), Commentaries on European VAT Directives* (IBFD 2016) chapter 1

⁴⁴ Article 6(1) TEU

made pursuant to some Treaty provision and the Union Courts will ensure such compliance.

Legislative acts are third in order of importance and they are legal acts adopted by a legislative procedure. They can comprise Regulations, Directives or Decisions provided they are adopted in accordance with a legislative procedure.⁴⁵ Delegated acts are secondary measures which are ‘non-legislative acts of general application’⁴⁶ and implementing acts are made pursuant to a legislative or delegated act.⁴⁷ The second tier of the hierarchy is discussed in the section 3.2.2.⁴⁸

3.2.2 General Principles of EU Law

General principles form part of primary EU law and they play a key role in the development, interpretation and application of European tax law.⁴⁹ They derive from the laws of the Member States as Tridimas⁵⁰ describes them:

(...) the general principles of law are children of national law but, as brought up by the Court, they become *enfants terribles*: they are extended, narrowed, restated, transformed by a creative and eclectic judicial process.

The word ‘principle’ is derived from the Latin word ‘*principia*’, which means the starting point, the premise or initial source.⁵¹ Where reference is made to the general principles of law as a source of law in national or supranational legal systems, such reference usually connotes principles which are unwritten and which are derived by the courts from specific rules or from the legal system. Concrete rules, whether they are contained in legislation or judge-made law, can be viewed as specific expressions of underlying, more abstract, propositions of law on which the legal system is founded. Principles in that sense are derived by a process of abstraction and usually function as justification for concrete rules.

One can distinguish between principles that constitute general principles and principles *simpliciter*. General principles and principles *simpliciter* have a different degree of generality. Accordingly, general principles can be used to

⁴⁵ Art 289 TFEU

⁴⁶ Craig, *Burca* (n 42) 113

⁴⁷ Terra, *Kajus*, (n 43) chapter 1

⁴⁸ Tridimas disputes this and states that they are at par with the Treaties in his book *Tridimas, The General Principles of EC Law* (Oxford University Press 1999) 33

⁴⁹ Helminen M., *EU Tax Law – Direct Taxation*, Online Books IBFD, 2013 chapter one

⁵⁰ Tridimas (n 48) 33

⁵¹ Bernitz U., Groussot X. and Schulyok F., *General Principles of EU Law and European Private Law* (Kluwer Law International BV 2013) p. 46

justify specific ones.⁵² Several specific principles can be derived from the one general principle and are matured through the latter.⁵³

Unwritten general principles of EU law as well as those laid down in the Treaties and the Charter form part of the legal order of the EU.⁵⁴

Principles of law express duties which aim at achieving the fundamental values of the legal order.⁵⁵ According to Dworkin, principles are standards to be observed because they constitute a requirement of fairness, justice, or of some other dimension of morality which is imperative in every society. In Dworkin's opinion principles, are part of the law but unlike rules, they are not applicable in an all-or-nothing way: principles make possible a flexible interpretation of legislation Principles give reasons for deciding cases, even if the reasons are not conclusive ones.

Distinguished from rules, Sir Gerald Fitzmaurice, in his Hague lectures on international law, observed that a principle of law underlies a rule and explains the reasons for its existence. A rule answers the question 'what' whereas a principle answers the question 'why' of the law.⁵⁶ Dworkin also remarks, that both principles and rules point to decisions about legal obligations but do not give a specific direction as to a solution.⁵⁷ Rules, because of how specific and concrete they are, stipulate answers.

Flowing from the above, it is worth-noting that in State Aid matters therefore, general principles of EU law are applied by the institutions to ensure coherence of their actions and general harmony with the EU legal system. The Court may in this light declare acts of the Commission invalid where such acts defeat the purpose of the principles. In instances, such as in the matter being discussed, where rules are silent, principles may be relied on to determine the matter.

⁵² Bayles, *Principles of Law: A Normative Assessment*, Law and Philosophy, 1987

⁵³ Groussot X., *Creation, Development and Impact of the General Principles of Community Law: Towards a jus commune europaeum* (Lund, 2005) 193. E.g. Right to be heard, an umbrella principle from which flow right to access to information, right to be heard in a reasonable time

⁵⁴ Terra, *Kajus*, (n 43) Chapter 1

⁵⁵ Hans Gribnau, "The Rule of Law, Judicial Review and The Principle of Equality" in G.T.K. Meussen (ed) *Principle of Equality in EU Taxation* (The Hague: Kluwer, 1999) 19

⁵⁶ Sir Gerald Fitzmaurice, 'The General Principles of International Law' (1957) 92 *Collected Courses of The Hague Academy of International Law*, p. 7; Bernitz., Groussot, and Schulyok (n 50) 48 para b

⁵⁷ Peter Gabel and Ronald Dworkin, 'Taking Rights Seriously' (1977) 91 *Harvard Law Review*.

3.3 Judicial Review of Community Acts

State Aid rules⁵⁸ are targeted at ensuring that there is decreased distortion of market conditions within the EU and that entities have a level playfield where they can thrive.⁵⁹ Though the aim is to promote a decent existence in human society, at the same time they can become an infringement upon the rights and freedoms of these entities many times due to the grounds stated in Article 263 TFEU. This tension is accommodated by the principle of the rule of law.

The rule of law implies the exercise of power according to the law and governing through laws which have been pre-established. However, this ideal picture is liable to distortion. In the realm of taxation and State Aid, the actors (institutions) may offer insufficient guarantees to the citizen because of the failure to implement general legal principles in the process of making legal acts.⁶⁰ Consequently, taxpayers or Member States will appeal to the court. From their independent position, the EU Courts aim at correcting the subjectivity of the institutions by attaching increasing importance to legal principles and fundamental rights.

Within the EU, the importance of the general principles cannot be overemphasized. It was in the *Stauder* case that the general principles of EU law were embraced by the Community Courts.⁶¹ Being the second tier of the hierarchy, the general principles sit below the Treaties and are used for the interpretation of the latter. They sit above the Legislative, Implementing and Delegated Acts and aside being used to interpret these norms they serve as ground for invalidation of a legislative, delegated or implementing act which conflicts the principles.⁶² Where there is conflict between Community act and the principles, the former gives way for legitimacy to prevail.⁶³ The overarching nature of general principles is vividly expressed in the *Unifruit* case, where the CJEU stated:

‘The Community does not incur liability on account of a legislative measure which involves choices of economic policy unless a sufficiently serious breach of a superior rule of law for the protection of the individual has occurred. Such a breach may arise out of ... an infringement of the principles of the protection of legitimate

⁵⁸ By rules the author refers the Treaty provisions, directives, regulations, decisions

⁵⁹ Article 107 TFEU

⁶⁰ Directives, Regulations, Decisions

⁶¹ Case C-29/69 *Stauder v City of Ulm* ECLI:EU:C: 1969:57

⁶² *Craig, Burca* (n 42) 110

⁶³ *Hans Gribnau* (n 55) 19

expectations, of legitimate expectations, of proportionality or of equal treatment...”

In addition, the general principles are trustworthy guidelines on which the judges can orient themselves. It is a cause for concern if leaving the law to the judgement of the judiciary by the application of principles is safe. According to G.F Gaus,⁶⁴ due to the ‘epistemological competence’ of judges, which is derived from their specialised legal training, judges are experts at applying the law and are fit to review legislation. A common justification is the fact that by way of expressing and enforcing their opinions about societal expectations and demands, they act like democratic institutions feeding expectations and breeding common understanding of the legal system of the society. A factor which ensures that they carry out this task without fail is the fact they are constantly under public scrutiny and criticism to which they respond.⁶⁵

In the ongoing case between Fiat Chrysler Finance Europe and the EC which is an appeal against the EC’s Decision (inter alia the application of an EU-ALP), the CJEU has been called upon to determine whether the EC declaration that its ALP derives from Union law violates the EC’s obligation under Article 296(2) to justify the principle of legitimate expectation. The applicants also seek to find out what this ALP is and for the court to clear the confusion about when transfer pricing analysis can violate EU state aid rules. It will be interesting to know to what extent the CJEU declares the so-called EC ALP as consistent with the principle of legal certainty.

3.4 Competence of the EC

3.4.1 Case study of the Belgian Excess Profit Aid

The Lisbon Treaty introduced competence categories for different subjects. Article 2(1) TFEU establishes the category of exclusive competence which allows only the Union to legislate and adopt legally binding acts. Member states can only do so if empowered by the Union or for the implementation of Union acts. The establishment of competition rules necessary for the functioning of the internal market is one of the subject areas⁶⁶ for the exercise of exclusive competence by the Union institutions. As an expression of the Union’s exclusive competence to establish the internal market and to ensure

⁶⁴ G.F.Gaus, *Justificatory Liberalism: An Essay on Epistemology and Political Theory* (Oxford University Press, Oxford, 1996) 276.

⁶⁵ Hans Gribnau (n 55)

⁶⁶ Others include customs union, monetary policy for Member States, conservation of marine biological resources under the common fisheries policy.

the elimination of discrimination, the EC in compliance with Article 108 TFEU issues Decisions⁶⁷ to Member States to abolish or alter aid. Where it finds that aid granted by the State or through State resources is not compatible with the internal market having regard to Article 107 or that such aid is being misused, it decides that the State concerned abolishes or alters such aid within a period to be determined by the EC.

This exclusive competence of the EC finds its foundation in Article 17(1) TEU which indicates that the EC must ensure the application of the Treaties and the law made pursuant thereto. It is also required to oversee the application of Union law under the control of the Courts⁶⁸. In this capacity, the EC is seen to possess judicial powers which it demonstrates as ‘investigator and initial judge’⁶⁹ of a Treaty violation in two important areas; state aid and competition policy. Although its Decisions can be reviewed, this role gives it the mandate and significant tool for the development of EU policy which may translate to law.

Additionally, whether exclusive or shared, competence or power to act may be expressly provided or may be implied from the interpretation of the Treaties. Where the EU institutions claim that a Treaty provision contains an implied power to act in a certain way, that power may be seen in a broad or narrow sense. In the broad sense, the existence of an objective, simpliciter, implies the existence of the power to take actions reasonably necessary to attain that objective. However, in the narrow sense of the term, the existence of a given power implies the existence of any other power that is reasonably necessary for the exercise of that given power. Both have been embraced by the CJEU. In the *Germany v Commission* case⁷⁰, one issue was whether the Decision of the EC establishing a prior communication and consultation process before immigrant workers enter that Member State was beyond the scope of its power in Article 153 (Article 118 then) TFEU since that provision did not give this power expressly to the EC. The ECJ, now CJEU stated:

(...) it must be emphasized that where an article of the EEC Treaty — in this case Article 118 — confers a specific task on the Commission it must be accepted, if that provision is not to be rendered wholly ineffective, that it confers on the Commission necessarily and per se the powers which are indispensable in order to carry out that task. Accordingly, the second paragraph of Article 118 must be interpreted

⁶⁷ Article 289 TFEU

⁶⁸ Article 258 TFEU

⁶⁹ *Craig, Burca* (n 46) 86

⁷⁰ *Joined Cases 281,283 to 285 and 287/85 Germany, France, Netherlands, Denmark And United Kingdom v Commission* ECLI:EU:C:1987:351 para 27,28

as conferring on the Commission all the powers which are necessary to arrange the consultations. In order to perform that task of arranging consultations the Commission must necessarily be able to require the Member States to notify essential information, in the first place in order to identify the problems and in the second place in order to pinpoint the possible guidelines for any future joint action on the part of the Member States; likewise, it must be able to require them to take part in consultations.

It follows from the above quote that the EC has exclusive competence to take decisions after investigation and assessment. The decisions are binding on the Member States to whom they are addressed. Can the EC claim to have an implied power to make postulations of principles which are unprecedented and unknown to the EU? If it does, what are the fetters on this power? How far can the EC go?

According to Craig and Burca, the EC may by way of ‘expressing the formal conclusion of its inquiry in relation to a Member state’,⁷¹ through its Decisions, ‘establish general procedures’⁷² subject to appeal by the State.⁷³ This finds expression in EU law,⁷⁴ where the EC is tasked to oversee the application of Union law under the control of the CJEU. It can be inferred that the EC has an implied power in the narrow sense to make postulations necessary for carrying out its tasks, subject to review by the CJEU. The given power in this context is found in Articles 107 and 108 TFEU. In making its decisions, which it addresses to the Member states, it may be necessary to introduce “general procedures”⁷⁵ which though unprecedented, are useful in achieving its purpose. The EC is encouraged to do this in its policy-making role under the EU,⁷⁶ in so far as such a move complies with EU law. Can one say however, that the EC went too far in making such a postulation regarding the fact that it must exercise its competence within the remit of EU law? Since EU law includes principles such as the principle of legal certainty, which begs foreseeability of the rules, did the EC exceed its competence? Has there been a breach of the principle of legal certainty and legitimate expectations?

⁷¹ Craig, Burca (n 42) 86 para 2

⁷² Craig, Burca (n 42) 86 para 2

⁷³ Article 108 TFEU

⁷⁴ Article 17 TFEU

⁷⁵ Craig, Burca (n 42) 86

⁷⁶ Article 16 TEU

4 Principle of Legal Certainty

The principle of legal certainty forms the very essence, the *raison d'être*⁷⁷ of the law reflecting the necessity for clarity, stability and intelligibility of the law.⁷⁸ The Court has defined the principle as requiring that legal rules be clear and precise, aiming to ensure that legal relations and associated circumstances governed by EU law remain foreseeable.⁷⁹ The principle applies both as a rule for interpretation and a substantive right. The latter aspect contains sub-concepts like non-retroactivity, acquired rights and legitimate expectations.⁸⁰ Tridimas distinguishes between the principle of legal certainty and that of the protection of legitimate expectations in the following manner: the former provides for certainty regarding legislation at a certain moment in time, whereas the latter concerns reliance on a law or policy in present time which will be applied in same manner to future situations.⁸¹

4.1 Principle of legitimate expectation

This principle has been applied as an overriding principle used to test the legality of the acts of the institutions and Member states. According to case law of the EU courts, the protection of legitimate expectations is based on the concept that reliance on Community legal order must be respected.⁸² Thus it hinges on the fundamental premise that those subject to the law must know what the law is to be able to plan their lives accordingly. Where there have been representations by Community institutions pertaining to specific assurances of what is right and what is not, causing an EU subject to entertain justified hopes,⁸³ the principle of legal certainty may be applied to restore legitimate expectations. The principle may however be invoked as against Community acts only to the extent that the Community itself has previously created a situation giving rise to a legitimate expectation.

⁷⁷ Fromont, 'Le principe de securite juridique', AJDA 1996 edition speciale, p.178

⁷⁸ C-63/93 Fintan Duff, Liam Finlay, Thomas Julian, James Lyons, Catherine Moloney, Michael McCarthy, Patrick McCarthy, James O'Regan, Patrick O'Donovan v Minister for Agriculture and Food and Attorney General. ECLI:EU:C:1996:51 para 20

⁷⁹ C-63/93 (n 78) para 20

⁸⁰ Groussot (n 53) 282

⁸¹ Cecile Brokelind, *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD, 2014) 247

⁸² Case 5/75 Deuka Deutsche Kraftfutter GmbH B. J. Stolp v Einfuhr- und Vorratsstelle für Getreide und Futtermittel ECLI:EU:C:1975:88 p. 767

⁸³ Case T-489/93 Unifruit Hellas EPE v Commission (1994)

4.2 Tripartite test

The following have emerged as the tripartite test applied in determining whether the act of the institution is in line with the principle :⁸⁴

- Is there an assurance arising from the conduct or legislation?
- Is there an expectation worthy of protection?
- Is there an overriding interest?

4.2.1 Specific assurance arising from conduct

The expectation must be provoked by an authoritative action of a public authority where the entity has given assurance in a specific direction.⁸⁵ The expectation may arise from the legislation or conduct.

Case law has it that mere public utterances by Commission authorities are not enough basis on which Members may rely to order their affairs. Hence in *Sodima*, where the applicants sought to rely on repeated public statements and comments issued by a Commission member stating that legitimate expectations already created were strengthened by them, the Court stated:

(...) the Court of Justice has consistently held, to be able to rely on the principle of the protection of legitimate expectations (...) the applicant must be able to show expectations based on specific assurances by the Community institution or conduct by that institution such as to give rise to pardonable confusion in the mind of a party acting in good faith and with all the diligence required of a normally informed businessman. ***That does not apply to public statements of a general nature by a member of the Commission or repeated contacts between the person concerned and the Commission after a letter of formal notice to it.***

The pronouncement of the EC in the *Belgian Excess Profit Decision* does not constitute mere public statements. Rather, it forms part of a formal Decision which is considered a binding legal act on the persons to whom it is addressed. The binding nature of earlier Decisions on the selective advantage of MNE pricing arrangements are enough to build public confidence and assurance based on which Members may arrange their affairs. They may thus constitute specific assurances.

In *Mulder*,⁸⁶ the Community passed a regulation in which milk producers could cease milk production for a period due to excess supply of milk on the EU market, in exchange for a premium. The applicant applied to resume

⁸⁴ AG Geelhoed in Case C-491/01 *British American Tobacco* ECLI:EU:C: 2002:476 para 271;

⁸⁵ Case C-74/74 *CNTA v Commission* ECLI:EU:C: 1976:84 pp.802-806

⁸⁶ Case 120/86 *J. Mulder v Minister van Landbouw en Visserij* ECLI:EU:C:1988:213

production after 5 years and not to be subject to the payment of an additional levy. Although this was a right assured to milk producers who stopped production, under the regulation, the application was refused. The applicant pleaded that the regulation was invalid because it breached the principle of legal certainty and protection of legitimate expectations, since those persons who took advantage of the system introduced by Regulation No 1078/77 were entitled to expect to be able to resume production upon the expiry of their non-marketing undertaking without paying. It was held that where a person had relied on assurances that flows from a Community measure and refrains from pursuing an undertaking, he may legitimately expect to enjoy the benefits his forbearance brings.

Likewise, where the prior Decisions have never referred to an EU-ALP but have consistently applied the OECD-ALP, taxpayer and Member States are more likely than not to expect the same course of conduct. Any alteration in the extent to which this assurance may be relied on should be explicitly communicated in advance of a Decision.

4.2.2 Expectation worthy of protection

This concerns the issue of the legitimacy of the expectations. An expectation is worthy of protection if the expectation is justified. Expectations are justified if Community institutions gave specific assurances which gave rise to reasonable expectations.⁸⁷ The specific assurances are in that sense apparently legal.

Expectations are created and considered legitimate (worthy of protection) after observing the conduct of both the Community authorities and the applicant. An expectation is worthy of protection where two fundamental requirements are present: good faith and foreseeability. They must be found in the conduct of both the applicant and the institution. Hence the applicant cannot rely on this if the applicant has not been truthful, or wrong in his or her or its conduct. Also, where the institution has committed an error the applicant cannot rely on the error to raise an issue of liability. Where it is also clear that the change in conduct or position of the institution is foreseeable, the applicant cannot cry foul. If a prudent taxpayer could have foreseen the change then the applicant is likewise deemed to have had the ability.⁸⁸

This feature was emphasised in the British Steel case in which the court stated that the applicant could not legitimately expect that a given legal situation

⁸⁷ Case T-489/93 (N 87)

⁸⁸ Case 265/85 Van de Bergh en Jurgens and Van Dijk Food Products v Commission (1987) ECR 1155; Case 22/94 Irish Farmers Association ECLI:EU:C: 1997:187; Groussot (n 57) (Lund, 2005)

would remain unchanged even though the economic conditions in the steel market were subject to changes which in some cases called for specific measures of adjustment.⁸⁹ The court added that ‘in certain circumstances, it is possible to foresee the application of specific measures intended to deal with clear critical crisis situations, with the effect that the principle of protection of legitimate expectations cannot be relied on’.

In relation to the aim of foreseeability, the nature and wording⁹⁰ of the statement, instrument or conduct or measure is key. The principle requires that the effect of Community action must be clear and predictable as stipulated in the SIAT case.⁹¹ The ECJ, as it was known then, held that though the Belgium’s legislation (the special rule laid down in Article 54 of the 1992 Belgian Income Tax Code) which limited the deductibility of expenses pursued legitimate objectives, it did not satisfy the principle of legal certainty due to its lack of clarity and unpredictability. The ECJ attributed its lack of clarity to its failure to specifically outline the aspect of the Belgian tax system which was deemed to confer an advantage to resident companies which conduct business with other resident companies. Also in Unifruit, the Court stated that any trader regarding whom an institution has given rise to justified hopes may rely on the principle of the protection of legitimate expectations. However, if a prudent and discriminating trader (taxpayer in this case) could have foreseen the adoption of a Community measure likely to affect his interests, he cannot plead that principle if the measure is adopted.

In the cases preceding the Belgian Excess Profit, Fiat and Starbuck cases, the EC did not debunk the OECD-ALP as a determinant of whether profit allocation among MNEs met market conditions. Taxpayers as well as tax authorities had put their confidence in this assessment procedure. The change in this stance by declaring that the ALP relied on in these cases is an EU-ALP, is new. The lack of consistency makes that decision unpredictable and may thus constitute a breach of the principle of legitimate expectations.

On the issue of clarity of conduct, it is worth observing that the new ALP referred to by the EC was said to be “a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty, which binds the Member States and from whose scope the national tax rules are not excluded...” Here, it is not clear what this ALP is because the idea of it being ‘a general principle of equal treatment in taxation’ is not easy to comprehend. In this sense, will one say the EC ALP is to ensure that like situations are treated alike and different cases treated differently? Will it, like the principle

⁸⁹ Case C-1/98 British Steel ECLI:EU:C: 2000:644 para52

⁹⁰ Cases C-189,202, 205,208 and 213/02 P Dansk Rorindustri paras.209-232

⁹¹ C-318/10 SIAT ECLI:EU:C: 2012:415

of non-discrimination be applied only in cross-border situations? How does this principle fall within the realms of State Aid as a general principle of equal treatment? Will it mean that a determination that MNE profit allocation and determination is inconsistent with market conditions will only constitute State Aid where there is a comparable situation (in terms of non-discrimination)?

Also, could the applicants in the Belgian, Fiat and Starbuck cases have foreseen the use of the EC ALP instead of the OECD's? If not then legitimate expectations were not met and there is a likelihood of a breach of the principle. Because of the previous reliance on the OECD-ALP, there was no way this new ALP could have been foreseen.

4.2.3 An overriding interest

Proof of the breach of the principle of legal certainty and legitimate expectations does not necessarily inculcate the responsible party. In the SNUPAT⁹² case for instance the Court determined that the principle of legal certainty, important as it may be, cannot be applied in an absolute manner, but that its application must be combined with that of the principle of legality. Which of these principles should prevail in each case depends upon a comparison of the public interest with the private interests in question.

In the Mulder case, therefore the Court attempts to do this by comparing the private interest that is possibility to re-enter the market and that of the public being the necessity to reduce milk surplus; the former prevailed making it the landmark case of triumph for individual rights. In practice, it is unusual for private interests to override public interests and for the private party to succeed there must be evidence to show that the applicant could not have foreseen the change.⁹³

In the Belgian Excess profit, Fiat and Starbucks cases, the private interest to be protected may be the Member States and taxpayers being assured of the tool the EC applies in its assessments. Knowledge of the standard will enable them to arrange their affairs in a manner to escape liability. It can be inferred that the public interest sought to be protected by the Commission is probably to propagate a principle or guide for assessing MNE profit allocation in a manner that is reliable and promotes equal treatment of entities in a comparable situation. Thus, perhaps for the sake of the same legal certainty the EC seeks to propagate its own assessment standard. For a long time, it has relied on the OECD-ALP which is itself beset with challenges and is viewed

⁹² Joined cases 42 and 49/59 Société Nouvelle des Usines de Pontlieue Acières du Temple (SNUPAT) v High Authority of the European Coal and Steel Community ECLI:EU:C:1961:5

⁹³ Groussot (57)

as becoming unreliable with the pervasiveness of “intangible transactions”. According to Wilkie,⁹⁴ with the increasing influence of intangibles in MNE transactions and massive globalisation, many are questioning the appropriateness of the OECD-ALP in determining where income is earned. Expanding this view, Eden indicates that, typical situations are those in which both related parties to the transaction have valuable intangible assets that are not traded on the open market. How can one price intellectual property, which is not traded on the open market? What does one do when markets are missing or imperfect? A more complex problem, as seen in some of the cases under review, occurs when an MNE has several Research and Development (R&D) centres scattered around the world where the R&D centres co-develop technologies that are shared by the group. How should the downstream profits from exploiting these technologies be divided among the MNE group?

Likewise, many authors suggest that policy-makers take a look at the “normative” profits which would have accrued to one of the enterprises but have not accrued due to some conditions or the profits that are unavoidable.⁹⁵ Wilkie indicates that certain profits do not arise because of the “opportunistic exercise of corporate power defined by the organizational and transactional fictions that are the medium by which a group, as a group, functions” but because the parties are in a related group setting. He adds that it is time to give the principle a second look since intangibles have become the more important trading ‘items’. He puts it this way:

“The incumbent weaknesses of the arm’s length principle are even more exposed when “intangibles” are not “transactional” in ways typically understood by tax legislation and related law. The situation becomes decidedly more acute when the “intangibles” we are concerned about are the essence of a taxpayer whose transfers nevertheless are being tested for their “arm’s lengthedness” according to the TPG’s methodological propositions”

From these points as well as the Commission’s own statement,⁹⁶ it is evident the OECD-ALP has not for a while been viewed as an appropriate fool-proof standard. It is for the Courts to determine which interest overrides the other. However, it is clear from case law that the EC’s interest cannot be deemed to

⁹⁴ Wilkie (n 33) 141

⁹⁵ Picciotto, S., 2012. Towards Unitary Taxation of Transnational Corporations. Tax Justice Network; McIntyre, M., 2012. “Challenging the Status Quo: The Case for Combined Reporting,” *Tax Management Transfer Pricing Report* 20 (22), 22 March; Langbein, S. I., 1991. “Transfer Pricing and Economies of Integration,” in Morrison et al. (eds) *Transfer Pricing: The International Tax Concern of the 1990s*. Englewood Cliffs, NJ: Prentice Hall Law & Business; Wilkie, (n 37) 141

⁹⁶ Commission (n 43) 225

have overridden that of the private parties since there was no way the private parties could have foreseen the application by the EC of this standard. In any case if it did, there could have been other ways of introducing this standard so that the private parties would have been aware of the changes and planned accordingly. One way would have been to hold consultative fora with Member States at which the new principle could have been introduced. During such fora, the author questions whether the EC can apply the European Commission Impact Assessment Guidelines to improve the process. If possible, four analytical steps may be applied to derive the scope and substance of the policy: what is the problem; what are policy objectives; what are the policy options; what are the likely economic, social and environmental impacts.⁹⁷ After such consultation, a draft proposal of the policy direction pertaining to profit allocation among MNEs may be presented for joint agreement among the three institutions: European Parliament, the Council and the Commission.

In that manner, the EC will be fulfilling its democratic responsibility of making the law represent the values and view of the society for which it is made and giving citizens the opportunity to order their tax affairs in a manner that complies with EU law.

4.3 Abolition of OECD-ALP

The problems with implementing the ALP are real; ones that have been known for a very long time. However, should the baby be thrown away with the dirty water? It is the view of the author that since the ALP has been applied for so long, it is not totally useless. Rather than adopting a replacement, the author agrees with various authors⁹⁸ that the ALP should be invigorated. This way, the flaws of the system are addressed and there is incremental development of policy and analysis. According to Eden, addressing the workability of the current ALP rules in the context of twenty-first century MNEs does require retooling current transfer pricing practices.

It has been the widely-held view⁹⁹ that the ALP does not speak to the realities of MNE operations especially where there are no comparable situations; it avoids this by adopting fictions. Eden recommends that policy reform should focus on the *facts and circumstances since* “the best transfer pricing method

⁹⁷ Impact Assessment Communication, COM (2002) 276 final and SEC (2004) 1377; Impact Assessment Guideline, sec (2009) 92

⁹⁸ Eden Lorraine *The Arm’s Length Standard: Making It Work in a 21st-Century World of Multinationals and Nation States in Global Fairness Tax* (Oxford University Press, 2016) section 6.2.3; Wilkie (n 33) 141

⁹⁹ Wilkie (n 33)

is the one that most closely fits the facts and circumstances of the particular situation.” This view coincides with the BEPS¹⁰⁰ recommendation to focus on the economic substance behind the MNE’s transactions and not its formal title. The functions performed, assets provided, and risks assumed (as outlined in a functional analysis) must be the critical foundation for understanding the economics and business aspects of the MNE. The OECD Discussion Draft¹⁰¹ proposes the use of the Profit Split Method (PSM) in cases where no comparable situation exists. It has shaped the PSM as a method of profit allocation that takes into account all the facts and circumstances of a given transaction and because it is aimed at analysing the commercial and financial connections between the parties on a case by case basis. The use of a value chain analysis and functional analysis (as element of the ALP) brings the PSM in line with the ALP.¹⁰²

Eden also agrees with the approach advocated by the OECD for fine-tuning the ALP. That is, profits should be divided among the related parties in an MNE group based on assessments of the following:

- a) Each party’s legal and contractual rights and obligation.
- b) The economic substance in terms of the parties’ functions, assets, and risks
- c) The relative bargaining power of the parties, considering their realistically available options and alternatives.

Invariably these steps should be applied while focusing on the facts and circumstances of each case. These recommendations may be considered and contextualised to fit into the EU law fabric. Should a new principle be introduced, it is suggested that it be applied and tested in a transitional process for some time before becoming fully binding. This way MNEs and Member States will have the opportunity to get accustomed to it.

4.4 Liability of EC

It is worth-noting that challenges to Community actions based on the protection of legitimate expectations rarely succeed. This is because the Court expected the applicants to have foreseen the change in Community conduct and so they hold that the expectation is not worth-protecting.¹⁰³ However,

¹⁰⁰ OECD (Centre for Tax Policy Reform)

<http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm>

¹⁰¹ OECD (2016), Public Discussion Draft BEPS Actions 8-10 Revised Guidance on Profit Splits, OECD Publishing

¹⁰² OECD, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing) 2015

¹⁰³ Groussot (n 57) 310

applicants in the Fiat case have an opportunity to succeed if they can demonstrate that there was no way of foreseeing the change.

Where the Commission is unsuccessful in this attempt, and the action has been declared to be contrary to the principle of certainty, the CJEU shall declare the act null and void. The Commission will then be required to take steps to comply with the judgement of the Court. Compliance may take many forms common among which include eradicating the effect of the measure or simply refraining from adopting an identical measure. This order however is directed only at the interested parties and will not require the institution to re-examine identical decisions which could have been affected by the same irregularity.

5 Application of the Principle of Equal Treatment to EC ALP

It has been indicated by some Transfer Pricing practitioners and jurists,¹⁰⁴ that the EC could have avoided the confusion created by its introduction of a new ALP by simply using the principle of equality as its assessment criteria. The question remains - would this be a more precise standard for determining selective benefit in profit sharing among MNEs?

5.1 Principle of Equality

According to the EC, the EC-ALP is a general principle of equal treatment. If so, it may mean that it must aim at ensuring that similar situations are treated the same and different circumstances treated differently in a cross-border situation, unless a difference of treatment is objectively justified.

There are two forms of the principle equality: formal and substantive equality. The first refers to enforcement and requires equality before the law. The second refers to the content of laws. It requires that laws must not discriminate between citizens on arbitrary grounds. The latter is of more interest in this paper. The two terms non-discrimination and equality have been used interchangeably in this paper.¹⁰⁵

The principle of equality occurs in three areas: prohibition of discrimination on grounds of nationality, prohibition of sex discrimination and prohibition of anti-competitive conduct. The prohibition of discrimination on grounds of nationality is implemented in specific spheres of Community law by several Treaty provisions.¹⁰⁶ The prohibition requires that Member States exercise their competence consistently within Community law. It confers on nationals of Member States, the status of nationals of the EU. Nationals of the EU who are in the same situation enjoy the same treatment in law in the Member States irrespective of their nationality or residence.

¹⁰⁴ Wattel (n 6) 792

¹⁰⁵ A distinction is sometimes drawn between non-discrimination and equality. The former requires abstention from discriminatory treatment while the other means that the notion of positive obligations is more apparent. However, this is not drawn in the case law of the EU judiciary which seems to consider the terms equality and non-discrimination as interchangeable

¹⁰⁶ Free movement of goods (article 34); free movement of persons (article 21, article 45, article 49); freedom to provide or receive services (article 56); and free movement of capital and payments (article 63)

5.2 Breakdown of EC ALP

Two features stand out about the EC ALP: it is a general principle of equality and it falls within the application of Article 107 (1) TFEU.

For the principle of equality to apply, there must be a comparable situation between the undertakings under review and a cross-border situation

To determine whether undertakings are in a comparable situation, the Court will normally have recourse to the criterion of competition which are their production¹⁰⁷ or their legal structure¹⁰⁸ or degree of exposure to risk.¹⁰⁹ For two undertakings to be in a comparable situation, it is sufficient, in principle that they are potentially in competition. A different situation exists where this criterion of competition is not satisfied.

The tax situation concerned is a cross-border tax situation if a taxpayer possessing the nationality of a Member State has made use of one or several of the TFEU basic freedoms, such as the freedom of establishment in another Member State. There must necessarily be two Member States involved and not an internal domestic situation.

It can be deduced that the EC ALP being in line with the principle of equal treatment may mean that it will be applied to ensure that pricing or arm's length profit approved between companies in a group is not discriminatory. This may mean further that group companies which are resident or nationals of the Member State of assessment (hereinafter called the Member State) are given the same treatment as non-resident or non-national standalone companies; whereas companies in different situations are treated differently. In its decision, the EC treats the group of companies and standalone entities as like corporations. Although this has been disputed by some jurists, it is assumed this is so for the sake of the discussion in this paper.

The EC indicates that the EC ALP falls within the application of Article 107 (1) TFEU. It appears that the EC ALP will be used in the assessment of State Aid cases. According to the EC, the purpose of applying EC ALP is to ensure that regardless of the method used to determine the pricing or distribution of arm's length profit, it will ensure that group of companies are not treated better (set an advantageous position) than the independent companies.

¹⁰⁷ Case 14/59 *Pontà Mousson v. High Authority* ECLI:EU:C: 1959:31

¹⁰⁸ *Joined Cases 17 and 20/61 Klöchner v. High Authority* ECLI:EU:C: 1962:30

¹⁰⁹ *Case 139/77 Denkavit v. Finanzamt Warendorf* ECLI:EU:C:1978:126

5.3 Possible application to State aid cases

Several conclusions can be drawn from the deductions in the previous section. In matters concerning profit allocation and determination among MNEs, to determine a violation of the aid rules, there must be present a cross-border element, a comparable situation and a different treatment. Without these present the principle cannot be used to assess these types of cases.

The EC may attempt to segregate the cases into those in which the EC ALP may apply and those in which it will not. However, will the taxpayer who seeks to arrange its affairs in a manner that complies with EU law be able to foresee which principle applies to what case? What standard will Member States adopt and enforce?

This approach is likely to defeat the purpose of the principle of legal certainty because already certain features of the principle of non-discrimination still beg for clarity and proper definition. These include inter alia, the determination of what constitutes a comparable situation and what does not; the category of cases that may be classified as different; what situations may be justified where there is a breach of the principle. There already exists a quagmire of confusion as these issues have not been clarified. Hence, to include these complexities to the already complex form of State Aid selectivity analysis may not auger well for development of EU law.

Moreover, the Court has held that the State aid review competences do not allow the Commission to derogate from Treaty provisions other than those relative to the application of Articles 107 and 108 TFEU more so when dealing with other Treaty provisions with direct effect. The Court had this to say in Hansen¹¹⁰ about the difference between State Aid review process and review of discriminatory measures:

“the application of those provisions presupposes distinct conditions peculiar to the two kinds of State measure which they are intended to govern and they differ furthermore as to their legal consequences, above all in that the intervention of the Commission plays a large part in the implementation of Article [107 and 108] whilst Article 37 is intended to be directly applicable”

Also, the case *Germany v. Commission*¹¹¹ is instructive. It concerns the validity of a Commission decision declaring that the German measure in which a roll-over tax relief was granted for capital gains reinvested in SMEs

¹¹⁰ Case C-91/78 Hansen GmbH & Co. v Hauptzollamt Flensburg ECLI:EU:C: 1979:65

¹¹¹ Case C-156/98 Federal Republic of Germany v Commission of the European Communities ECLI:EU:C:2000:467

established in the new German Länders infringed the freedom of establishment. The Commission held it as incompatible State aid. As a procedural matter, Germany challenged the Commission Decision because the Commission should not have established an infringement of Article 49 TFEU of a review procedure pursuant to Article 108(2) TFEU. AG Saggio,¹¹² in his opinion in this case, considered that Germany was right in its contention that the former Article 49 could not be used as legal basis for the contested decision as was adopted following a special ‘abbreviated’ procedure for State aids, which provides for derogation from the general infringement procedure referred to in Articles 258 TFEU. The opinion of AG Saggio is observed as follows:

“It is clear from the wording of Article (108) that the power of the Commission to adopt the decisions in question is not general in nature, but is strictly limited to cases in which it considers that a Member State has infringed the rules of the Treaty on State aid. However, the Commission cannot have recourse to the special procedure provided for in Article (108) of the Treaty to declare a national measure incompatible with other rules of the Treaty, in this case, those which guarantee freedom of establishment, since in these cases the Commission must follow the procedure set out in Article [258] of the Treaty, which offers more ‘safeguards’ for the Member State concerned. 44. From the foregoing it is clear that, in the part where the tax system adopted by Germany is stated to be in breach of the provisions of the Treaty on freedom of establishment, the decision appears to be vitiated by lack of competence.”

The cardinal principle to be drawn from these cases is the fact that the EU can only exercise its competences on the basis of the principle of conferral set in Article 5 TEU. In most fields, the EU’s competence is not exclusive, and both the EU and the Member States are competent to act. For this reason, the prohibition of national tax measures which discriminate against the free movement principle have direct application in the national legal systems. Though the two sets of rules have as their essence the prohibition of any tax discrimination, one difference is that the scope of tax measures prohibited by the restriction to fundamental freedoms is limited to any discrimination to the detriment of cross border situations. These are to be left for the CJEU to determine.

¹¹² AG Saggio in C-156/98 (n 111)

The Commission has limited competence when it comes to determining whether a measure amounts to a restriction of Treaty freedoms or discrimination. As the Commission indicates in its Notice:

[T]he Commission could not, however, authorise aid which proved to be in breach both of the rules laid down in the Treaty, particularly those relating to the ban on discrimination and to the right of establishment, and of the provisions of secondary law on taxation. Such aspects may, in parallel, be the object of a separate procedure on the basis of Article [258]. As is clear from case-law, those aspects of aid which are indissolubly linked to the object of the aid and which contravene specific provisions of the Treaty other than Articles [107 and 108] must however be examined in the light of the procedure under Article [108] as part of an overall examination of the compatibility or the incompatibility of the aid.

Principally, under Article 258, the EC merely has the power to deliver an opinion concerning the infringement of the Treaty provision, (in this case of the fundamental freedoms or non-discrimination) to the Member State. where the latter fails, it submits its concerns to the CJEU. If this is so the question will be whether the application of the principle of equal treatment in the assessment of State Aid cases means that the EC is determining whether a breach of the freedoms has occurred. If this is so the EC may lack the competence to assess MNE profit allocation and determination using the principle of equal treatment, except those aspects of the discrimination which are linked to the object of the aid. However, if the application of the principle in its assessment does not amount to determining whether a restriction exists, then the EC may be able to apply the principle.

6 Conclusion

Globalization has led to a tremendous amount of cross-border trade and investment, which supports economic growth, creates jobs and fosters innovation. As with the economy, businesses have become more international and today MNEs represent a large proportion of global business activities. Being considered an integral part of the economy of Member States, the latter usually issue tax rulings to provide MNEs with legal certainty and predictability on the application of general tax rules. The EC has held some of these tax rulings to constitute prohibited illegal state aid.

In the Belgium Excess Profits, Fiat and Starbucks Decisions the EC has declared that the EU has its own ALP. Even though the EC having its own State Aid assessment tool is laudable, this sudden introduction may not be compatible with the principle of legal certainty.

The results arrived at after the compatibility analysis between the EC ALP and the principle of legal certainty is that though the EC has the power to make such declarations, it must do so within the remits of the EU law. It is the view of the author that the EC breached the principle of legal certainty since it had over time accepted the use of the OECD-ALP but refused to apply same in a matter where citizens expected it to. In view of this, it is expected that the CJEU may in the matter of Fiat appeal balance the public interest with private party interest and determine if a breach properly so-called has been committed.

The author shares the view that the OECD-ALP should not be discarded but may be refined to tackle the challenges that come with its application. Efforts at fine-tuning the ALP includes the application of the principle that profits should be divided among the related parties in the MNE group based on an assessment of (1) each party's legal and contractual rights and obligations; (2) the economic substance in terms of the parties' functions, assets, and risks; and (3) the relative bargaining power of the parties, considering their realistically available options and alternatives. This approach should be made consistent with EU law.

However, if the EC seeks to adopt an ALP which is a general principle of equal treatment and a fulfilment of Article 107 (1) TFEU, it may imply that there must be present a comparable situation or a different treatment.

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