



Lund University

School of Economics and Management
Department of Business Law

Fiscal Sovereignty and State Aid in the field of Direct Taxation of EU Law

By

Kristina Lyrenäs

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Supervisor Sigrid Hemels

Examiner Cécile Brokelind

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Author's contact information:

kristinalyrenaes@hotmail.com

+46 793402352

Contents

- Contents.....ii
- Abstract. 1
- Preface..... 2
- Abbreviation list..... 3
- 1 Introduction..... 4
 - 1.1 Background..... 4
 - 1.2 Aim 6
 - 1.3 Method and material 6
 - 1.4 Delimitation 7
 - 1.5 Outline 7
- 2 State aid article 107(1) TFEU. The conditions for State Aid. 8
 - 2.1 Incompatibility with the internal market - State aid as a regulatory tool. 8
 - 2.2 Aid granted by a Member State or through State resources through direct taxation... 9
 - 2.3 Direct taxation distorts or threatens to distort competition and affects trade between Member States. 10
 - 2.4 Favouring certain undertakings or the production of certain goods – selective advantage and the notion of discrimination..... 10
 - 2.4.1 The reference system..... 11
 - 2.4.2 Comparability..... 12
 - 2.4.3 Justification. 13
 - 2.5 Gibraltar – a change of approach? 13
 - 2.6 Conclusion 14
- 3 Fiscal sovereignty in EU direct taxation and the division of competence. 15
 - 3.1 Sovereignty and fiscal sovereignty..... 15
 - 3.2 Direct taxation a Member State competence with limits..... 17

3.3	State aid, a Union competence with limits.	18
3.4	State aid, the division of competence and the <i>principle of equality</i>	19
3.5	Conclusion	20
4	How has State aid been applied by the Commission in its recent decision with relation to fiscal sovereignty.....	21
4.1	The recent Commission decisions.	21
4.2	The reference system used in the Commission decisions.....	22
4.3	The arm’s length principle inherent in Article 107(1) TFEU.....	23
4.3.1	The arm’s length principle endorsed by the CJEU.	25
4.4	Qualification issues of Apple and Engie and untaxed profits.	25
4.4.1	Apple.	25
4.4.2	Engie.....	26
4.4.3	The Belgian excess profit exemption scheme.	27
4.5	Other issues.....	27
4.5.1	The anti-avoidance rules in Engie.	27
4.5.2	The Belgian excess profit exemption scheme appeal.....	29
5	Analysis.....	29
5.1	Introduction.	29
5.2	Analysis of the reference system and comparability of group and stand-alone companies.	30
5.3	Analysis of the arm’s length principle in 107(1) TFEU.....	31
5.4	The analysis of the qualification issues in Apple and Engie and the untaxed profits. 32	
5.5	The analysis of the anti-avoidance rule.	34
5.6	Conclusion analysis.	34
6	Conclusion and outlook.	35
	Bibliography.....	37

Abstract.

This thesis investigates if the recent decisions by the Commission on State aid in direct tax law are intruding on the EU Member States' fiscal sovereignty. The author concludes that the Commission's basic legal arguments of the reference system, being the corporate income tax system of the relevant Member States, as well as the arm's length principle as a tool to assess selectivity in article 107(1) TFEU, are problematic from a fiscal sovereignty point of view. The research conducted has established the Commission's basic legal arguments in the recent decisions to be that the reference system should be the corporate income tax system of the relevant Member States, the arm's length principle is part of the assessment tool of selectivity in article 107(1) TFEU, qualification mismatches resulting in non-taxation may constitute a selective advantage and so does not applying a GAAR to a domestic tax arrangement. The analysis has shown the State aid article 107(1) TFEU to be a competition law tool aimed at protecting the internal market and fiscal sovereignty to be a principle and as such its application is variable depending on the circumstances of the situations. Therefore, the EU holds, and is limited to, sovereignty in the policy area of competition law. The Member States hold sovereignty in direct tax law, but this sovereign right is limited by the Member States commitments to the EU. The analysis conducted in this thesis shows that provided that the Commission is pursuing the aim of ensuring that the internal market is free from competitive distortion, the answer to the question central to this thesis will one of proportionality, if the Commission goes beyond what is necessary to achieve the aim. In conclusion, the author argues that if the CJEU endorses the Commission's basic legal argument of reference system this will reduce the fiscal sovereignty of the Member States. If the CJEU endorses the Commission's view of the arm's length principle, this will involve a standard setting in direct tax legislation that belong to the fiscal sovereignty of the Member States.

Preface

This thesis has mainly been written in two geographical locations.

The first geographical location is the office of KPMG in Malmö. I would like to extend my sincere gratitude to KPMG for housing me, providing me with technical resources, expert knowledge, companionship, printing facilities, lots of coffee and above all, making me feel very welcome. A special thank you goes to Henrik and Magnus for recruiting me.

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Abbreviation list

AG	Advocate General.
APA	Advanced Pricing Agreement.
BEPS	Base Erosion Profit Shift.
BPOT	Business Property Occupation Tax.
CFC	Controlled Foreign Company.
CFI	Court of First Instance of the European Communities.
CJEU	Court of Justice of the European Union.
Commission notice	Commission Notice on the notion of State aid as referred to in Article 107(1) of the TFEU EU.
Commission	European Commission.
EU	European Union.
GAAR	General Anti-Avoidance Rule.
i.e.	id est.
MNE	Multi National Enterprise.
OECD	Organisation for Economic Co-operation and Development.
TEU	Treaty of the European Union.
TFEU	Treaty of the Functioning of the European Union.
The Treaties	TEU and TFEU.
TP	Transfer Pricing.
UK	United Kingdom.
U.S.	United States of America.
VAT	Value Added Tax.
WTO	World Trade Organization.

1 Introduction

1.1 Background

In recent years State aid, the taxation of multi-national enterprises (MNEs) and the issue of tax-avoidance has been brought into the public spotlight for debate.¹ The engagement of tax planning activities by some high profile MNEs such as *Apple*, *Starbucks*, *Fiat* and *Amazon* have sparked public outrage² followed by demands for MNEs to pay their fair share of taxes.³ Following the European Commission's (the Commission) decision to initiate several formal investigations procedures, examining whether Member States such as Ireland, Luxemburg and the Netherlands, have complied with State aid rules, the Commission concluded the existence of illegal State aid in multiple cases and thus ordered the relevant Member States to recover taxes due from MNEs such as Apple,⁴ Starbucks,⁵ Fiat⁶ and Amazon.⁷ Tasked with the effective enforcement of competition rules in the State aid area, the European Union (EU) Commissioner for Competition, *Margarethe Vestager*,⁸ justifies the Commission decisions by stating that Member States are prohibited from giving tax advantages to selected companies, that companies need to pay their fair share of taxes and artificial arrangements that reduces companies tax burdens are illegal.⁹

This triggered another debate among States concerning who has the authority, the obligation and right to tax the MNEs and which state or supra-national organization has the right to decide on how to tax the MNEs.¹⁰ In a letter addressed to the President of the European Commission, *Jean-Claude Juncker*, the United States of Americas (U.S.) Secretary of the Treasury, *Jacob J. Lew*, claims that the Commission is pressurizing the EU Member States to tax MNEs on income that rightfully should be allocated to the U.S. tax base, contrary to "well-established international tax standards" and in a manner that undermines the U.S. tax treaties with EU Member States.¹¹ Responding to the letter, Vestager, conveys the EU's aim of establishing fair tax competition within the EU. State aid given to selected companies provides them arbitrarily, with an advantage denied their competitors. The EU State aid rules are to be used to limit

¹ See for ex. Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int'l L.J. 1017 (2015), p.1018, Farrell, S. & McDonald, H., *Apple ordered to pay €13bn after EU rules Ireland broke state aid laws*, The Guardian (30 Aug. 2016), Toplensky, R., *Amazon and Apple hit by EU crackdown*, Financial times (4 Oct. 2017) and Bodoni, S., *Fiat's EU Court Showdown Gives a Taste of Fight Over Apple Taxes*. Bloomberg (21 June 2018).

² See ex. Barford, V., & Holt, G., *Google, Amazon, Starbucks: The rise of "tax shaming."* BBC News Magazine. (21 May 2013) and <https://www.bbc.com/news/technology-43196502>.

³ See ex. Peston, R., *UK Uncut protests over Starbucks "tax avoidance"*. BBC News. (8 Dec. 2012) and Myerson, J. *How do we protest about Amazon's tax avoidance?*. The Guardian. (4 Dec 2012).

⁴ Commission Decision SA.38373 Apple.

⁵ Commission Decision SA.38374 Starbucks.

⁶ Commission Decision SA.38375 Fiat.

⁷ Commission Decision SA.38944 Amazon.

⁸ Mission letter from Jean-Claude Juncker, *President of the European Commission to Margrethe Vestager, Commissioner for Competition*, (1 Nov. 2014).

⁹ European Commission press release, *State aid: Commission finds Luxembourg gave illegal tax benefits to Amazon worth around € 250 million*, (4 Oct. 2017), European Commission press release, *State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion*, (30 Aug. 2016), 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*, (21 Oct. 2015).

¹⁰ European Commission press release, *State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion*, (30 Aug. 2016) and Government of the Netherlands, *Point of view of the Netherlands at the General Court of the European Union on Starbucks*, (02 Jul. 2018).

¹¹ Letter from Jacob J. Lew, *U.S. Secretary of the Treasury to Jean-Claud Juncker, President of the European Commission*, (11 Feb. 2016).

aggressive tax planning and Base Erosion Profit Shifting (BEPS) by closing loopholes and combating mismatches in the EU Member States tax systems.¹²

Also, within the EU there is lack of unanimity concerning the Commission's recent decisions on State aid in direct tax law on Starbucks, Fiat, Apple, *Belgian excess profit exemption scheme*,¹³ Amazon and *Engie*.¹⁴ Ireland, Netherlands and Luxembourg have all appealed the Commission decisions.¹⁵ The Netherlands' government argued that EU Member States are autonomous in the field of direct taxation, and that the Commission is over-stepping the limits of its competence by expanding the application of State aid legislation.¹⁶ Adding to the disaccord is Vestager statement in the Apple-case that the onus on Ireland to collect taxes due from Apple can be reduced if other states tax profits belonging to Apple that can be allocated to their respective tax base.¹⁷

The opinion of legal scholars is forked. Some scholars are of the opinion that the Commission's current approach is both welcomed in the fight against tax avoidance but also a natural legal evolution of State aid practice.¹⁸ Others mean that the Commission is extending its given competence and is trespassing on the fiscal sovereignty of the Member States¹⁹ and that State aid rules are not a viable tool to be used to hamper aggressive tax planning.²⁰ The Commission definition of aggressive tax planning is the (ab)use of mismatches between two or several tax jurisdictions.²¹ All though the implementation of the anti-tax avoidance directives are aimed at combating aggressive tax planning²² the Court of Justice of the European Union (CJEU) has on several occasions held that there is no Community law that solves adverse consequences which are the result of disparities between Member States exercising in parallel their fiscal sovereignty.²³

Against this background the question central to this thesis emerges:

Are the recent decisions by the Commission on State aid in direct tax law intruding on the EU Member States' fiscal sovereignty?

¹² Letter from Margrethe Vestager, *European Commissioner for Competition*, to Jacob J. Lew, *S. Secretary of the Treasury*, (29 Feb 2016).

¹³ Commission Decision SA.37667 Belgium excess profit exemption scheme.

¹⁴ Commission Decision SA.44888 Engie.

¹⁵ T-778/16, *Ireland v. Commission*, T-760/15, *Netherlands v. Commission*, T-755/15, *Luxembourg v Commission*, T-816/17 *Luxembourg v Commission* and T-516/18, *Luxembourg v Commission*.

¹⁶ Government of the Netherlands, *Point of view of the Netherlands at the General Court of the European Union on Starbucks*, (02 Jul. 2018).

¹⁷ European Commission press release: *State Aid: Ireland gave illegal tax benefits to Apple worth €13 billion*, (30 Aug. 2016).

¹⁸ Lyal, R., *Transfer Pricing Rules and State Aid*, 38 *Fordham Int'l L.J.* 1017 (2015), p. 1018.

¹⁹ Mason, R., *The Tax Subsidy war*, p.1-2.

²⁰ Lyal, R., *Transfer Pricing Rules and State Aid*, 38 *Fordham Int'l L.J.* 1017 (2015), p. 1043.

²¹ European Commission: *The Commission recommendation of 6 December 2012 on aggressive tax planning* (2012/772/EU), preamble (2).

²² Council Directive (EU) 2016/1164 of 12 July 2016, *laying down rules against tax avoidance practices that directly affect the functioning of the single market*, preamble, p.3 and Council Directive (EU) 2017/952 of 29 May 2017, amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

²³ See ex. C-298/05, *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt*, EU:C:2007:754. para. 43-45.

1.2 Aim

The aim of this thesis is to:

Identify if the Commission's basic legal arguments in the recent decisions on State aid in direct tax law is intruding on the fiscal sovereignty of the EU Member States based on the division of competence governing direct taxation in EU legislation?

The author's ambition is to contribute to the legal discussion and to enhance legal clarity for the benefit of both companies as well as governments.

To fulfill the aim of this thesis the following questions of issue will be treated;

- How should State aid as per article 107(1) TFEU be understood?
- What is fiscal sovereignty?
- What is the limitation of the EU Member States' competence in direct taxation in relation to State aid?
- What are the basic arguments the Commission has applied in their most recent²⁴ State aid decisions where the outcome of the decisions is negative with recovery?

1.3 Method and material

The method used for this thesis is the legal dogmatic research method. The legal dogmatic research method provides a pure legal perspective and is characterized by a hierarchical systematization of relevant sources of law.²⁵ By identifying relevant sources of law and interpreting them in a systematic manner the legal dogmatic research method provides a process that sheds light on reality, strengthens legal certainty and may assist in predicting future legal developments.²⁶ The starting point for the method is to identify the relevant sources of EU tax law.²⁷ The relevant sources consist of written and unwritten European or (inter)national rules, principles, concepts, doctrines, case law and literature.²⁸ As the CJEU has the authority to interpret the Treaties, CJEU case law is vital for the conclusions made.²⁹ The CJEU engages in legal dogmatic research method to conform rules and principles of international law. This adds to the importance of the legal dogmatic research method as by supporting this method, legal scholars contribute to achieving a coherent and consistent application of EU tax law.³⁰ In addition to CJEU case law, the Commission's recent decisions naturally play a fundamental part in reaching the aim of this thesis. In Chapter 5, comments and ideas expressed by *Monsenego* in the Kluwer Competition law blog has been used. I am aware that a blog does not hold the academic value of a publication, nevertheless due Monsenego's academic credentials and the newsworthiness of the Engie decision, I have opted to use the blog in my analysis.

²⁴As mentioned in the introduction of the thesis the most recent Commission decisions for the understanding of this thesis are: Commission Decision SA.38375 Fiat, Commission Decision SA.38374 Starbucks, Commission Decision SA.38373 Apple, Commission Decision SA.38944 Amazon, Commission Decision SA.37667 Belgium excess profit exemption scheme and Commission Decision SA.44888 Engie.

²⁵ Douma, S., *Legal research in international and EU tax law*, Kluwer: Deventer, 2014, p. 17-18.

²⁶ Douma, S., *Legal research in international and EU tax law*, Kluwer: Deventer, 2014, p. 24 & p. 39.

²⁷ Douma, S., *Legal research in international and EU tax law*, Kluwer: Deventer, 2014, p. 38.

²⁸ Douma, S., *Legal research in international and EU tax law*, Kluwer: Deventer, 2014, p. 18.

²⁹ Article 267 TFEU.

³⁰ Douma, S., *Legal research in international and EU tax law*, Kluwer: Deventer, 2014, p. 38-39.

1.4 Delimitation

This thesis deep-dives into EU State aid law, fiscal sovereignty and the Commission decisions on State aid in the field of direct taxes. To maintain focus on the aim of the thesis, some delimitations are necessary.

To reach the aim of this thesis fiscal sovereignty and State aid relation to direct taxes will be investigated. All other taxes or charges are out of scope. Trade law and World Trade Organization (WTO) law are closely connected to State aid, as the central question of this thesis is EU State aid law, trade law and WTO rules fall out of scope. How to recover State aid when there is no obvious reference benchmark system has been discussed among scholars,³¹ as the author views this to be a problem that occurs after illegal State aid has been established, for the purpose of this thesis, this conundrum falls out of scope. This thesis focuses on Commission decisions that are negative with recovery, the Commission decision on *McDonald's* will not be part of this thesis.³² The United Kingdom (UK) Controlled Foreign Company (CFC) rules have come under the scrutiny of the Commission.³³ The Commission judged the UK scheme to be in part classified as illegal State aid. Although the Commission press release has been issued, the formal decision is still pending. For this reason the details of the Commission's reasoning are unknown and will therefore not be part of this thesis. In all the Commission decisions the MNEs concerned have been given the opportunity to comment. As the aim of the thesis is centered on the dynamics between fiscal sovereignty of the Member States and the competence of the EU, the MNEs opinion lack relevance and are out of scope for this thesis. This thesis is not intended to provide for a comprehensive discussion on all issues potentially related to the Commission's recent decisions on State aid, only the relation between the Commission's basic argumentation and fiscal sovereignty. Harmful tax competition, BEPS, fundamental freedoms and correct or incorrect transfer pricing (TP) methods will only be discussed to the extent of furthering the questions central to the aim of this thesis.

1.5 Outline

Chapter 2 analysis the State aid rules in article 107(1) TFEU. The aim of the Chapter is to answer the question, how State aid as per article 107(1) TFEU should be understood in the context of direct taxes. The cumulative criteria of State aid in article 107(1) TFEU are examined. A deeper understanding of the criteria selective and advantage, the challenge of establishing a reference system and the evolution of State aid in CJEU case law, is needed as it is central in answering the question of this thesis. Chapter 3 serves to analyse and understand, what fiscal sovereignty is, and what competence the Member States and the EU hold respectively with regards to State aid and direct tax law. Chapter 4 dissects the recent Commission decisions on State aid as well as the tribunals judgment of the Belgian excess profit exemption scheme on State aid. The focal point is to single out the Commission's basic legal arguments. Chapter 5 analysis the Commission's basic arguments in relation to the Member States' fiscal sovereignty and discusses which basic arguments of the Commission may be in

³¹ See ex. Wattel, P.J., *Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters*, World Tax Journal, 2013.

³² European Commission press release, *State aid: Commission investigation did not find that Luxembourg gave selective tax treatment to McDonald's*, (19 Sep. 2018).

³³ European Commission press release, *State aid: Commission concludes part of UK tax scheme gave illegal tax advantages to certain multinational companies; remaining part does not constitute aid*, (2 Apr. 2019).

discord with the division of competence governing direct taxation in EU legislation. Chapter 6 provides for a conclusion and a forward outlook.

2 State aid article 107(1) TFEU. The conditions for State Aid.

The wording of State aid article 107(1) TFEU reads as follows:

“Save as otherwise provided in the Treaties, 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.”

2.1 Incompatibility with the internal market - State aid as a regulatory tool.

The starting point of State aid is the unequal treatment of undertakings in comparable situations.³⁴ To establish illegal State aid four cumulative criteria as stated in Article 107(1) TFEU need to be satisfied.³⁵ If the criteria are satisfied, the aid is deemed to be State aid that is incompatible with the internal market. That is, unless otherwise is provided in the Treaties and/or if none of the derogations provided for in article 107(2) and 107(3) TFEU are fulfilled.³⁶ State aid should therefore be understood in the context of the EU aims and the internal market. The internal market definition rests on the four freedoms³⁷ and is described as an area free from internal frontiers that allows for the free movement of goods, persons, services and capital within the borders of the internal market and in accordance with the Treaties.³⁸ The EU objective is market integration³⁹ and to a certain extent market unity.⁴⁰ Within the internal market the EU is committed to working towards a balanced economic growth and a highly competitive social market.⁴¹ The Commission considers State aid that is devised to target recognised market failures and objects of common interests to be *good State aid*.⁴² The Commission argues that good State aid can promote growth without interfering and distorting competition within the internal market.⁴³ The Commission further reasons that well-designed and targeted State aid can contribute to the taxpayer’s money being spent more wisely as the Commission claim’s that State aid rules facilitate for stricter allocation and improved quality of the spending of public finances.⁴⁴ For the internal market to function as intended, the internal

³⁴ Lopez, H.L., *General thoughts of Selectivity and Consequences of a Broad Concept of State Aid in Tax Matters*, European state aid law quarterly, 2010, p. 812.

³⁵ The four cumulative criteria of State aid will be discussed in the following sections of this thesis.

³⁶ There are also the General Block Exemption rules and regulations in article 109 TFEU. According to Micheau, these provisions play a limited role in tax matters, Michau, C., *State Aid, Subsidy and Tax Incentives under EU and WTO Law*, Kluwer Law International, 2014, p. 101.

³⁷ Article 20 TFEU, Article 21 TFEU, Article 28 TFEU, Article 49 TFEU, Article 56 TFEU, Article 63 TFEU and Wattel P. J., *European Tax Law*, Wolters Kluwer, 2018, p.23-24.

³⁸ Article 26(2) TFEU.

³⁹ Article 3(3) TEU, Michau, C., *State Aid, Subsidy and Tax Incentives under EU and WTO Law*, Kluwer Law International, 2014, p.37 and Wattel, P. J. *European Tax Law*, Wolters Kluwer, 2018, p.3.

⁴⁰ Barents, R., *The Single Market and National Tax Sovereignty as in*, Jansen, S.J.J.M (ed.), *Fiscal Sovereignty of the Member States in an Internal Market*, Kluwer, 2011, p. 54.

⁴¹ Article 3(3) TEU.

⁴² COM(2012) 209 final, *On EU State aid modernization*, p.12.

⁴³ COM(2012) 209 final, *On EU State aid modernization*, p.12.

⁴⁴ COM(2012) 209 final, *On EU State aid modernization*, p. 5 and p. 14.

market is reliant on undistorted conditions of competition.⁴⁵ Companies from different Member States need to be able to operate anywhere within the EU on equal or almost equal terms to facilitate the workings of the internal market.⁴⁶ Hence, deemed incompatible and prohibited are actions, that may affect trade between Member States by preventing, restricting or distorting competition with the internal market.⁴⁷ State aid not targeted at market failures or objects of common interests, is deemed to be a waste of public finances, and runs risk of having a harmful impact on competitive conditions. Harmful State aid risks hampering growth by distorting competition and interferes with the EU aim of facilitating a level playing field⁴⁸ within the internal market. Harmful State aid may also increase unwanted protectionism from Member States and thus runs risk of coming into collision with the founding objective of market integration within the EU.⁴⁹ As there is good State aid and harmful State aid, the State aid rules in articles 107-109 TFEU, should be viewed as a regulatory filter system that separates permissible or justifiable aid *i.e.* good State aid, from prohibited, harmful State aid.⁵⁰

2.2 Aid granted by a Member State or through State resources through direct taxation.

The first criterion that needs to be satisfied in article 107(1) TFEU is that the aid needs to be granted by a Member State or through State resources. Although the wording gives the impression that there is a distinction between on the one hand, aid granted by a Member State and on the other hand, through State resource, no distinction should be made between the two.⁵¹ For this criterion to be fulfilled, it is clear that the aid is required to be imputable to one Member State. Discrepancies between States taxing jurisdictions', which result in an advantage for the taxpayer, is not within the scope of State aid.⁵² Aid that is a result of measures the Member State is required to implement under EU law cannot be imputable to the Member State⁵³ unless the Member State enjoys a certain amount of discretion when implementing the measure.⁵⁴

⁴⁵ Wattel P. J., *European Tax Law*, Wolters Kluwer, 2018, p.23-24 as well as the second cumulative criterion of article 107(1) TFEU.

⁴⁶ Pålsson, R., *Equality in Taxation: Reflections on the Social Construction of Comparability in Tax Law*, as in Brokelind, C., (ed.), *Principle of law: Function, Status and Impact in EU Tax Law*, IBFD, 2014, Chapter 7.3.1.

⁴⁷ Article 101 TFEU as well as article 107(1) four cumulative criteria.

⁴⁸ As expressed in article 101-109 TFEU and see Wattel, P.J., *European Tax law*, Wolters Kluwer, 2018, p.3. and Wattel, P.J., *Stateless Income, State Aid and the (Which?) Arm's Length Principle*, Intertax, 2016, p. 792. The OECD definition of a *level playing field* which is: "A level playing field in global trade means that all countries and firms compete on an equal footing to offer consumers everywhere the widest possible choice and value for money.

<http://www.oecd.org/trade/topics/levelling-the-playing-field/>

⁴⁹ COM(2012) 209 final, *On EU State aid modernization*, p.12, p.14 and Micheau, C., *State Aid, Subsidy and Tax Incentives under EU and WTO Law*, Kluwer Law International, 2014, p. 37.

⁵⁰ Michau, C., *State Aid, Subsidy and Tax Incentives under EU and WTO Law*, Kluwer Law International, 2014, p.37 and Luja, R. H.C., *Do State Aid Rules Still Allow European Union Member States to Claim Fiscal Sovereignty?*, EC Tax Review, 2016, p. 319.

⁵¹ Michau, C., *State Aid, Subsidy and Tax Incentives under EU and WTO Law*, Kluwer Law International, 2014, p.160.

⁵² Douma, S., *State Aid and Direct Taxation*, as in Wattel, P.J, *European Tax Law*, Wolters Kluwer, 2018, p. 465.

⁵³ C-460/07, *Sandra Puffer v Unabhängiger Finanzsenat, Außenstelle Linz*, EU:C:2009:254, para. 70 and 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 at 44.

⁵⁴ C-189/15, *Istituto di Ricovero e Cura a Carattere Scientifico (IRCCS) — Fondazione Santa Lucia v Cassa congugaglio per il settore elettrico, Ministero dello Sviluppo economico, Ministero dell'Economia e delle Finanze, Autorità per l'energia elettrica e il gas*, EU:C:2017:17, para. 47-51 and 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 at 45.

The aid needs to come directly or indirectly⁵⁵ through State resources. Direct tax law does not involve actual transfer of State resources from the State to the recipients. However, as the State forgoes collecting taxes, taxpayers who are relieved from paying taxes enjoy a beneficial financial situation in comparison to other taxpayers from which the State has collected taxes. Therefore, the criterion, through State resources, in article 107(1) TFEU is fulfilled.⁵⁶ When the tax authorities of a Member State provide MNEs with tax rulings, there is a demarcation between providing tax rulings to enhance legal certainty and providing tax rulings that facilitate illegal State aid as the Member State is then foregoing State resources.⁵⁷ Whereas the former is not a problem, the latter is.

2.3 Direct taxation distorts or threatens to distort competition and affects trade between Member States.

The second and the fourth criteria needing to be satisfied to establish the presence of illegal State aid are, the aid needs to distort or threaten to distort competition and this needs to affect trade between Member States. These two criteria carry a low set threshold for fulfilment.⁵⁸ In an area where there is competition, competition is generally deemed to have been distorted or threatened to have been distorted, when a company operating in a liberalised sector is strengthened financially by State aid.⁵⁹ Although, there is no need for the competition to be drastically distorted⁶⁰ there needs to be some distortion to the competition in the market. Purely speculative distortion will not suffice as to satisfy the criterion.⁶¹ The CJEU has held that, as far as affecting trade between Member States, there is no requirement that the aid has affected trade, the mere risk is adequate for the criterion to be fulfilled.⁶²

2.4 Favouring certain undertakings or the production of certain goods – selective advantage and the notion of discrimination.

Offering goods or services on a market constitutes an undertaking in the meaning of article 107(1) TFEU. Regardless, of legal status or way of being financed, any entity or entities that are engaged in economic activity constitutes an undertaking.⁶³

Closely connected are the criteria of selective and advantage.⁶⁴ To establish if a tax measure provides an advantage and is selective, a benchmark comparison against what is considered to

⁵⁵ T-358/94, *Air France v Commission*, EU:T:1996:194, para. 63.

⁵⁶ C-78/08, *Paint Graphos and Others*, EU:C:2011:550, para. 46 and C-106/09 P, *Commission and Spain v Government of Gibraltar and United Kingdom*, EU:C:2011:732, para. 72.

⁵⁷ C-6/12, *P Oy*, EU:C:2013:525, para. 24-30.

⁵⁸ Douma, S., *State Aid and Direct Taxation*, as in Wattel, P.J., *European Tax Law*, Wolters Kluwer, 2018, p. 474. and 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, at 189 & 190.

⁵⁹ T-298/97, *Alzetta v Commission*, EU:T:2000:151, para. 81.

⁶⁰ Douma, S., *State Aid and Direct Taxation*, as in Wattel, P.J., *European Tax Law*, Wolters Kluwer, 2018, p. 474. and 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, at 189.

⁶¹ C-280/00, *Altmark Trans and Regierungspräsidium Magdeburg*, EU:C:2003:415, para. 79.

⁶² C-518/13, *Eventech Ltd v The Parking Adjudicator*, EU:C:2015:9, para. 65.

⁶³ C-222/04, *Cassa di Risparmio di Firenze and others*, EU:C:2006:8, para. 107-108.

⁶⁴ Schön, W., *Tax legislation and the Notion of Fiscal Aid: A Review of 5 Years of European Jurisprudence*, as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p.8.

be the normal rule, needs to be performed.⁶⁵ In the case *Paint Graphos and Others*,⁶⁶ the CJEU provides a circular three-step analysis on how to establish a selective advantage.⁶⁷

First, it needs to be established what is the normal rule in the Member State tax regime. By identifying what the normal or general applicable tax rule is, the general applicable tax rule is to be used as a point of comparison or a benchmark system for reference. The second step, establishes if a tax measure deviates from the benchmark system and thus, provides for selectivity by different treatment between undertakings who are in a comparable factual and legal situation. The third step, examines if the different treatment can be justified in light of the benchmark system established in the first step *i.e.*, in light of the objective assigned to the tax system of the Member State concerned.⁶⁸

2.4.1 The reference system.

Pinpointing the applicable reference system, is not always a straightforward exercise.⁶⁹ In academic writing the conundrum of what is the exception and what is the main rule has been addressed.⁷⁰ However, in the *Commissions Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union* (the Commission Notice), the Commission provides examples of what may constitute suitable systems of reference. Signalling that the reference system should be derived from the Member States own tax legislation the Commission Notice gives some possible reference systems. Mentioned are, the *corporate income tax system*, the *Value Added Tax (VAT) system* or the *general system of taxation of insurance*. The Commission Notice also mentions “stand-alone” levies and how these levies may constitute their own reference systems.⁷¹ Schön identifies two different categories of benchmarks, the first category consisting of measures aimed at raising revenue for the State. In the revenue raising category, the benchmark system will typically be the *ability to pay principle* and the features that the legislator has chosen to be reflected in the ability to pay principle, such as income, net wealth or consumption. The second category are taxes that have a regulatory aim, in which case it is the regulator aim that is the relevant benchmark to be used.⁷²

⁶⁵ See for ex. C-81/10 P, *France Télécom SA v European Commission*, EU:C:2011:811, para 18.

⁶⁶ C-78/08, *Paint Graphos and Others*, EU:C:2011:550. The three step criteria is reiterated in for ex. T-219/10 RENV, *World Duty Free Group, SA v European Commission*, EU:T:2018:784, para. 63-65.

⁶⁷ See also Commissions notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, at 128-129.

⁶⁸ C-78/08, *Paint Graphos and Others*, EU:C:2011:550, para. 49 and See also Ismer R., & Piotrowski, S., *The Selectivity of Tax Measures: A Tale of Two Consistencies*, Intertax, 2015, p.561.

⁶⁹ See for ex. Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int'l L.J. 1017 (2015), p. 1029, and Ismer R., & Piotrowski, S., *The Selectivity of Tax Measures: A Tale of Two Consistencies*, Intertax, 2015, p.561.

⁷⁰ Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int'l L.J. 1017 (2015), p. 1034.

⁷¹ Commissions Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, at 133-134, and Schön, W., *Tax Legislation and the Notion of Fiscal Aid: A review of 5 Years of Jurisprudence*, as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p.9.

⁷² Schön, W., *Tax Legislation and the Notion of Fiscal Aid: A review of 5 Years of Jurisprudence*, as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p.11.

2.4.2 Comparability.

Paint Graphos and Others facilitates what may be a starting point of an evolution of State aid case law as regards the second step of the selectivity analysis concerning comparability.⁷³ In the selectivity analysis of for example *Adria-Wien Pipeline*,⁷⁴ the CJEU expresses that the analysis should be made “in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question.”⁷⁵ This CJEU viewpoint represents the traditional approach of the CJEU up until the *Paint Graphos and Others* case. In the case, the CJEU expands the selectivity analysis⁷⁶ by stating that measures are selective if they “favour certain undertakings or the production of certain goods by comparison with other undertakings which are in a comparable factual and legal situation, in the light of the objective pursued by the corporation tax regime, namely the taxation of company profits.”⁷⁷ The CJEU approach in *Paint Graphos and Others* is reconfirmed in consecutive CJEU case law⁷⁸ leading scholars to deduce there to be a change to the State aid practise.⁷⁹

The reference system is equally important when establishing the presence of an advantage. Although there are exceptions to the rule,⁸⁰ the criteria of selectivity and advantage are intertwined. Establishing a selective advantage requires a comparison to be made between the recipient of an advantage and undertakings which are in comparable legal and factual situations.

The comparison exercise can present challenges as illustrated in *Autogrill España*.⁸¹ In the initial judgment the Court of First Instance of the European Communities (CFI) established that as the disputed Spanish measure was open to all undertakings the measure was *de jure* not selective.⁸² In the appeal that followed, the tribunal stated that the Spanish measure was *de facto* selective as what should be the basis for the comparison is not if a measure is open to all undertakings, but if the undertakings who have availed themselves of the option of, in this case, the purchasing of shares in foreign companies, are in a comparable situation to companies who have purchased shares in national companies.⁸³ In both the initial judgement, as well as the appeal, it can be deduced that the undertakings, were considered to be in comparable factual and legal situations by the CFI. However, in the initial judgement the comparison lies between undertakings that have or have not purchased foreign shares, but both are free to do so, and in the appeal the comparison lies between undertakings that have purchased shares, foreign or

⁷³ Ismer, R. & Piotrowski, S., *The selectivity of Tax Measures: A Tale of Two Consistencies*, Intertax, 2015.

⁷⁴ C-143/99, *Adria-Wien Pipeline and Wieterdorfer & Peggauer Zementwerke*, EU:C:2001:598.

⁷⁵ C-143/99, *Adria-Wien Pipeline and Wieterdorfer & Peggauer Zementwerke*, EU:C:2001:598, para.41.

⁷⁶ Ismer, R. & Piotrowski, S., *The selectivity of Tax Measures: A Tale of Two Consistencies*, Intertax, 2015, and Galendi Junior, Ricardo André, *State Aid and Transfer Pricing: The Inherent Flaw Under a Supranational Reference System*, Intertax, 2018.

⁷⁷ C-78/08, *Paint Graphos and Others*, EU:C:2011:550. para.54.

⁷⁸ C-6/12, *P Oy*, EU:C:2013:525, para. 19 and C-522/13, *Ministerio de Defensa and Navantia*, EU:C:2014:2262, para. 35 and 40.

⁷⁹ Ismer, R. & Piotrowski, S., *The selectivity of Tax Measures: A Tale of Two Consistencies*, Intertax, 2015, and Galendi Junior, Ricardo André, *State Aid and Transfer Pricing: The Inherent Flaw Under a Supranational Reference System*, Intertax, 2018.

⁸⁰ C-308/01, *GIL Insurance Ltd and Others v Commissioners of Customs & Excise*, EU:C:2004:252, para 65-78.

⁸¹ T-219/10, *RENV, Autogrill España v Commission*, EU:T:2018:784, para 83-89.

⁸² T-219/10, *Autogrill España v Commission*, EU:T:2014:939, para 53-61.

⁸³ T-219/10 *RENV, Autogrill España v Commission*, EU:T:2018:784, para 82-89 and C-20/15 P, *Commission v World Duty Free Group*, EU:C:2016:981, para. 115-119.

domestic, where companies that have purchased foreign shares are provided with a selective advantage in comparison to undertakings that have purchased shares in domestic companies.

For individual aid schemes, such as tax rulings, the CJEU has established that as they are issued on an individual basis the presumption is that they are selective in nature.⁸⁴

2.4.3 Justification.

A difference in tax treatment that provides for an exception from the general tax system, may be justified if it is the feature of basic or guiding principles of the tax system, they are a part of. The *Paint Graphos* case states that there must be made difference, “between on the one hand, the objectives attributed to a particular tax regime and which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives.”⁸⁵ Provided that the measure is proportionate in relation to the objectives of the measure and does not go further than what is necessary to attain those objectives, it may be justifiable and if so, it is not selective.⁸⁶ If it is not selective, it does not constitute illegal State aid.⁸⁷

2.5 Gibraltar – a change of approach?

The *Gibraltar* case has been described as a “landmark case.”⁸⁸ It is debated whether the judgment facilitates for an actual change of CJEU practise or if it is just a mere exception to how State aid legislation should be applied.

The judgment concerns the corporate tax reform in *Gibraltar*.⁸⁹ In the CFI ruling and in the Advocate General (AG) opinion leading up to the final judgement, both the CFI and the AG failed to establish a normal rule to be used as a benchmark comparison.⁹⁰ In the final judgment the CJEU however, declared the tax regime to be selective. Gibraltar wanted to introduce a payroll tax and a Business Property Occupation Tax (BPOT) tax that where payable only if a profit was made by a taxable person. Both the taxes would be capped at 15% of the profits. The CJEU concluded the profit requirement would benefit unprofitable operators, whereas the capping would benefit very profitable operators. The CJEU ruled that this would be the result of random events during the assessment period and therefore did not constitute a selective advantage to certain undertakings or the production of certain goods.⁹¹ However, offshore companies, having no physical presence in Gibraltar, would enjoy a selective advantage. The CJEU stated that through the regulatory technic, certain undertakings where to benefit from a selective advantage even though they would be subject to the normal tax system. By combining

⁸⁴ C-15/14 P, *European Commission v MOL Magyar Olaj- és Gázipari Nyrt.*, EU:C:2015:362, para. 60.

⁸⁵ C-78/08, *Paint Graphos and Others*, EU:C:2011:550, para. 69.

⁸⁶ Douma, S., *State Aid and Direct Taxation*, as in Wattel, P.J, *European Tax Law*, Wolters Kluwer, 2018, p. 470.

⁸⁷ C-487/06, *British Aggregates Association v Commission of the European Communities and United Kingdom*, EU:C:2008:757, para. 82-83.

⁸⁸ See for ex. Schön, W., *Tax Legislation and the Notion of Fiscal Aid: A review of 5 Years of Jurisprudence*, as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p. 10.

⁸⁹ C-106/09 P and C-107/09 P, *European Commission and Kingdom of Spain v. Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland*, EU:C:2011:732.

⁹⁰ C-106/09 P and C-107/09 P, *Advocate Generals Opinion in European Commission and Kingdom of Spain v. Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland*, EU: C:2011:215, para. 155-175, and T-211/04 and T-215/04, *Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland v Commission of the European Communities*, EU:T:2008:595, para. 171-173.

⁹¹ C-106/09 P and C-107/09 P, *Advocate Generals Opinion in European Commission and Kingdom of Spain v. Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland*, EU:C:2011:215, para. 76-84.

different tax rules, an advantage would nevertheless be conferred upon them.⁹² Offshore companies, normally, have neither staff nor business property, hence the effect the tax system would produce, would be *de facto* selective and conferr an advantage upon offshore companies in comparison to onshore companies.⁹³

The issue in *Gibraltar* is that the normal rules where applicable to all companies in *Gibraltar* including the offshore companies, hence producing a problem in establishing a derogation from the benchmark or normal rules as per the three-step analysis. This gives rise to a debate as to whether the CJEU has moved away from the three-step derogation analysis, towards a discrimination test.⁹⁴ Both the Commission as well as Schön view the *Gibraltar* case to facilitate an exception from the main rule, which is that a measure needs to derogate from rules of a reference system defined by the Member State.⁹⁵

Lyal states that the generic treatment in the *Gibraltar* case may intrude on the Member States tax policy and is therefore problematic. *Lyal* opinions that cautious determination is required of how the comparative analysis should performed so to reach a legitimate differentiation. *Lyal* however concludes, that selectivity may well be established by comparing the tax burdens by undertakings using the general tax system as the reference framework.⁹⁶ *Luja* also addresses the fact that too generous interpretation of the State aid rules may impact the Member States' fiscal sovereignty. Drawing attention to the views expressed in the opinion of the case by AG Jääskinen, *Luja* judges the *Gibraltar* case to be all about, combating harmful tax competition and the scope of the State aid rules, urging the Member States to pay due care if they decide to exempt general streams of income or profit from corporate taxation.⁹⁷ AG Jääskinen expresses, in the opinion of the case, that the treaties mandate the State aid rules to apply to the field of competition law. The treaties do not confer upon the State aid rules the objective of combating harmful tax competition. Although AG Jääskinen views, combating harmful tax competition as an important legal quest, to use the State aid rules as a tool to do so, risks distorting the legal framework of the EU.⁹⁸

2.6 Conclusion

Article 107(1) TFEU should be understood as a competition law tool that has the objective of separating *good* State aid from illegal State aid. Out of the four cumulative criteria that need to be fulfilled for a tax measure to be deemed as illegal State aid, establishing if a measure is selective and provides for an advantage are closely linked. They also present the biggest challenges. The main challenge being to establish the normal rule or benchmark rule as well as establishing which undertakings should be compared to each other in view of their legal and

⁹² C-106/09 P and C-107/09 P, *Advocate Generals Opinion in European Commission and Kingdom of Spain v. Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland*, EU: C:2011:215, para. 88-93.

⁹³ C-106/09 P and C-107/09 P, *Advocate Generals Opinion in European Commission and Kingdom of Spain v. Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland*, EU: C:2011:215, para. 101-110.

⁹⁴ C-106/09 P and C-107/09 P, *Advocate Generals Opinion in European Commission and Kingdom of Spain v. Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland*, EU: C:2011:215, para. 176-189.

⁹⁵ Schön, W., *Tax Legislation and the Notion of Fiscal Aid: A review of 5 Years of Jurisprudence*, as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p. 10, and The Commissions notice at p. 129-130.

⁹⁶ *Lyal*, R., *Transfer pricing rules and State aid*, 38 *Fordham Int'l L.J.* 1017 (2015), p. 1039.

⁹⁷ *Luja*, R. H.C., *(Re) shaping Fiscal State Aid: Selected Recent Cases and Their Impact*, *Intertax*, 2012, p. 129-130.

⁹⁸ C-106/09 P and C-107/09 P, *Advocate Generals Opinion in European Commission and Kingdom of Spain v. Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland*, EU: C:2011:215, para. 134.

factual situations. CJEU case law evolution through the *Paint Graphos and Others* case has widened the scope of the benchmark test. The change of wording that the CJEU uses in the *Paint Graphos and Others* opens for a comparison to be made not only between undertakings hit by a specific measure but for a comparison between all undertakings under a Member State's corporate tax regime. The *Gibraltar* case may reveal another evolution of CJEU case law as there is a lack of a deviation from what may be considered the normal rule. This raises the question if the CJEU is moving away from the benchmark test towards a discrimination test. The *Gibraltar* case is inconclusive regarding the scope of the State aid rules and which role or function the State aid rules may play in order to combat harmful tax competition. Whilst case law evolution causes uncertainty, what seems to be clear is that the scope of State aid law has expanded in as much as it provides for a benchmark against *lex generalis* and not only *lex specialis*. This narrows the gap in which the Member States may manoeuvre without coming under the scrutiny of the State aid rules and as such limits the Member States' fiscal sovereignty.

3 Fiscal sovereignty in EU direct taxation and the division of competence.

3.1 Sovereignty and fiscal sovereignty.

In the article, *The Single Market and National Tax Sovereignty*, Barents summaries fiscal sovereignty in tax law as follows:

“Tax sovereignty reflects the inseparable relation between the sovereign state and its inherent prerogative to levy taxes within its territorial jurisdiction, as recognised by international tax law.”⁹⁹

Traditionally defined as absolute authority and power over a given territory, political area or jurisdiction and sovereignty is synonym with the concept of a State.¹⁰⁰ Sovereignty, as an absolute power, presumes there to be no higher authority than that of the sovereign state.¹⁰¹ From an international perspective, sovereignty includes the recognition and respect from other States with regards to territorial integrity and political autonomy.¹⁰²

The freedom for States to enter into undertakings, agreements and treaties that limit their jurisdiction is an expression of their sovereign rights.¹⁰³ For instance by becoming a Member of the Union, the EU Member States have committed to permanently surrender, and/or restrict their sovereign rights within a limited set of policy fields.¹⁰⁴ The crunch, when surrendering sovereign rights to supranational organisations, is knowing how much sovereignty is handed over, what is retained, and is the supranational organisation capable of conjuring new, or expanding existing areas of its allocated sovereignty.

⁹⁹ Barents, R., *The Single Market and National Tax Sovereignty*, as in Jansen, S.J.J.M (ed.), *Fiscal Sovereignty of the Member States in an Internal Market*, Kluwer, 2011, p. 58.

¹⁰⁰ Amtenbrink, F., and Raulus, H., *Contribution to: Fiscal Policy in the European Union Context - The Semi-detached Sovereignty of Member States in the European Union*, as in Jansen, S.J.J.M (ed.), *Fiscal Sovereignty of the Member States in an Internal Market*, Kluwer, 2011, p. 2-3.

¹⁰¹ Douma, S., *Optimization of Tax Sovereignty and Free Movement*, IBDF, 2011, p. 80.

¹⁰² Article 2(7) UN Charter.

¹⁰³ Isenbaert, M., *EC Law and the Sovereignty of the Member States in Direct Taxation*, Catholic University of Leuven, 2008, p. 67, and Douma, S., *Optimization of Tax Sovereignty and Free Movement*, IBDF, 2011, p. 79.

¹⁰⁴ *Van Gend en Loos v Administratie der Belastingen*, EU:C:1963:1 para. 3-4 and C-6/64, *Costa v E.N.E.L.*, EU:C:1964:66, para. 7.

Isenbaert argues, there are three different theories of how surrendered sovereign rights by a State to supranational organisations, eventuate. First, the idea that sovereign rights and competence are delegated by the State to the supranational level. The supranational organisation has no power of its own, only what has been given by the State in the given policy field. *Isenbaert* highlights, that although this is a popular viewpoint by many authors, evidence indicates that it is a rare reality. In most cases, the supranational organisation expands its competence.¹⁰⁵ Secondly, is the idea that sovereignty is shared between the State and the supranational level. *Isenbaert* argues that this approach is complex as it requires one of the “sovereign entities” to be more sovereign than the other one. Thus, it requires hierarchic division of the sovereignty concept and that is in dissonance with the definition of sovereignty being that of a unit that carries ultimate authority.¹⁰⁶

Isenbaert advocates the third approach to be that (Member) States enable the supranational organisation or EU to claim sovereign authority in given policy fields. For the EU, this creates a system of functional and constitutional pluralism, where EU law and the law of the Member States co-exists. EU law claims sovereignty/primacy over national law but only in accordance with the functions and objectives the EU is meant to fulfil. The EU supremacy is thus confined to those functions and objectives. Simultaneously, the Member States are excluded from making the same claim with regards to the functions and objectives allocated to the EU.¹⁰⁷ Hence, a dual exercise of sovereignty exists which creates comparable lateral legal claims by Member States and the EU at different levels and in different areas.¹⁰⁸

Amttenbrink and *Raulus* argue that, seen from the perspective, that it is the Member States who collectively are the ultimate decision makers in deciding how the Treaties should be amended,¹⁰⁹ it can be debated to what extent the Member States surrender their national sovereign rights. The competences handed over to the EU, stems from the Member States decisions to do so. Ergo, it is the Member States of the EU who hold the *Kompetenz-Kompetenze*, and the ultimate sovereignty.¹¹⁰ *Douma* summarizes sovereignty to be a principle rather than a rule of law.¹¹¹ Stating that if two units claim sovereign rights that collide with each other, one of the unit’s rights is not nullified but instead, one is given precedence in legal order, over the other, based on the circumstances at hand.¹¹²

Fiscal sovereignty traditionally gives rise to taxation at source within the Member States jurisdiction or territory. Examples of this is taxation of income that arises within the Member State geographical area or taxation of a person residing within the Member State territory.

¹⁰⁵ *Isenbaert, M., EC Law and the Sovereignty of the Member States in Direct Taxation*, Catholic University of Leuven, 2008, p. 68-69.

¹⁰⁶ *Isenbaert, M., EC Law and the Sovereignty of the Member States in Direct Taxation*, Catholic University of Leuven, 2008, p. 70-71.

¹⁰⁷ *Isenbaert, M., The Contemporary Meaning of "Sovereignty" in the Supranational Context of the EC as Applied to the Income Tax Case Law of the ECJ*, *EC Tax Review*, 2009, p.265-266 and *Isenbaert, M., EC Law and the Sovereignty of the Member States in Direct Taxation*, Catholic University of Leuven, 2008, p. 71-74.

¹⁰⁸ *Isenbaert, M., EC Law and the Sovereignty of the Member States in Direct Taxation*, Catholic University of Leuven, 2008, p. 72.

¹⁰⁹ Article 48 TEU.

¹¹⁰ *Amttenbrink, F. and Raulus, H., Contribution to: Fiscal Policy in the European Union Context – The Semi-detached Sovereignty of Member States in the European Union*, as in *Jansen, S.J.J.M.(ed.), Fiscal Sovereignty of the Member States in an Internal Market*, Kluwer, 2011, p. 10-11.

¹¹¹ *Douma, S., Optimization of Tax Sovereignty and Free Movement*, IBDF, 2011, p. 81-81.

¹¹² *Douma, S., Optimization of Tax Sovereignty and Free Movement*, IBDF, 2011, p. 81-81.

Nationality is a commonly used juridical base that States use to provide legitimacy for asserting tax claims. The definition and criteria of who is a national in a State is at the discretion of that State. Being a national of a State may give rise to tax claims by that State, on the national's worldwide income. The legal basis of territory, normally gives rise to unlimited fiscal claims on residents of the taxing State, whereas taxing claims on a non-resident, is limited to income that is attributed to sources within the territory of that State.¹¹³

Fiscal sovereignty for Member States in the EU, signifies the authority for the Member States to decide on how to raise revenue within their given territory through direct taxation. Member States' objectives are normally the funding or financing needed to fund government expenditure, the redistribution of income and other agreed political needs or aims. Fiscal sovereignty also signifies autonomy to use taxes as a policy instrument to curb or encourage behaviour deemed more, or less desirable within its territory.¹¹⁴ Member States remain responsible for financing their own public spending. It is within the authority of the Member States to decide on educational system, healthcare, defence, administration, system of justice *et cetera*. Therefore, it is quite logical that Member States retain the power to decide on how, what and by how much taxes should be levied to finance their public spending. This sovereign right also exists in the negative. The Member States have a sovereign right to refrain from levying taxes.¹¹⁵

3.2 Direct taxation a Member State competence with limits.

Although not explicitly stated in the Treaties, direct taxation is a competence shared between the EU and its Member States.¹¹⁶ The *principle of conferral*¹¹⁷ limits the competence the EU has in direct tax law by stating that in areas of shared competence the EU can act only to the extent that the objects of the proposed action cannot be achieved by the Member States.¹¹⁸ This implies that although the Member States retain sovereign rights to tax within their territory, their autonomy to exercise this right is affected and limited by commitments to the EU.¹¹⁹ This also means that harmonisation of EU law in the area of direct taxation, is only required to the extent it is aimed at achieving the EU objective of market integration.¹²⁰

Fiscal sovereignty and the division of competence requires unanimous agreement from all the EU Member States in order to legislate jointly in the field of direct taxation.¹²¹ The unanimity

¹¹³ Douma, S., *Optimization of Tax Sovereignty and Free Movement*, IBDF, 2011, p. 83-85.

¹¹⁴ Vanistendael, F., *Memorandum on the taxing powers of the European Union*, EC Tax Review, 2002, p. 120-121, and Isenbaert, M., *The Contemporary Meaning of "Sovereignty" in the Supranational Context of the EC as Applied to the Income Tax Case Law of the ECJ*, EC Tax Review, 2009, p. 267.

¹¹⁵ C-518/13, *Eventech*, EU:C:2015:9, para 43-44 and Schön, W., *Tax Legislation and the Notion of Fiscal Aid – A Review of Five Years of European Jurisprudence*, as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p. 2.

¹¹⁶ This can be derived from article 4(2)(a) TFEU.

¹¹⁷ Article 5 TEU.

¹¹⁸ Article 5(3) TEU.

¹¹⁹ See for ex. C-501/00, *Spain v Commission*, EU:C:2004:438, para. 123, C-417/10, *3M Italia*, EU:C:2012:184, para. 25., T-131/16, T-263/16, *Belgium v Commission*, EU:T:2019:91, para. 62-64 and Amtenbrink, F. and Raulus, H., *Contribution to: Fiscal Policy in the European Union Context – The Semi-detached Sovereignty of Member States in the European Union*, as in Jansen, S.J.J.M (ed.), *Fiscal Sovereignty of the Member States in an Internal Market*, Kluwer, 2011, p. 5 and Barents, R., *The Single Market and National Tax Sovereignty*, as in Jansen, S.J.J.M (ed.), *Fiscal Sovereignty of the Member States in an Internal Market*, Kluwer, 2011, p. 60.

¹²⁰ Article 113 TFEU and Isenbaert, M., *The Contemporary Meaning of "Sovereignty" in the Supranational Context of the EC as Applied to the Income Tax Case Law of the ECJ*, EC Tax Review, 2009, p. 267.

¹²¹ Article 115 TFEU.

requirement often leads to no EU legislation or EU legislation does not quite reach its objective, as it is the result of 28 Member States compromising.¹²² Instead soft law such as recommendations¹²³ and Codes of Conducts, that are not legally binding but may compel the Member States to cooperate in coordinating national tax policies as well as create a mutual understanding between Member States, is used.¹²⁴ Sometimes paving the way for legislation to be adopted.¹²⁵

Although the EU has some competence in direct taxation the functional sovereignty remains with the Member States.¹²⁶ However, neither the Treaties nor the Member States constitutional acts provides for a clear-cut division on how to allocate competence.¹²⁷ The CJEU have on several occasions held that direct tax law falls within competence of the Member States but the Member State has to exercise its competence consistently with EU law.¹²⁸ The CJEU has also expressed shared responsibility by stating that “in the current state of harmonisation of Community tax law, Member States enjoy a certain autonomy.”¹²⁹

3.3 State aid, a Union competence with limits.

State aid falls under the area of competition law,¹³⁰ which fall under the exclusive competence of the EU and the Commission.¹³¹ State aid, the principle of conferral as well as the division of competence are all sources of primary law, as such, they are of equal value.¹³² If a provision laid down by the Member States through law, regulation or administrative action, cause disruption to the internal market, the Commission has an obligation to consult the Member State and to ensure that the disruptive provision is disposed of.¹³³

The Commission’s authority to defend the internal market and to uphold the State aid rules is confirmed in the appeal against the Commission decision on the Belgium excess profit regime. Belgium pleaded the Commission to be in breach of the principle of conferral,¹³⁴ and therefore overstepping the limits of its competence¹³⁵ and intruding on the tax jurisdiction of Belgium.¹³⁶ The CJEU stated that even though Member States retain fiscal autonomy, the competence to design their tax base and spread the tax burden as deemed appropriate, they need to exercise these rights in accordance with EU law. Areas of direct taxation that are not harmonized, lie

¹²² European Commission press release, *A gradual transition to more efficient and democratic decision-making in EU tax policy – Questions and Answers*, (15 Jan. 2019).

¹²³ Article 288 TFEU.

¹²⁴ Nouwen, M. and Wattel P.J., as in, Wattel P.J., *European Tax Law*, Wolters Kluwer, 2018, p. 485.

¹²⁵ Nouwen, M. and Wattel P.J., as in, Wattel P.J., *European Tax Law*, Wolters Kluwer, 2018, p. 494.

¹²⁶ Vanistendael, F., *Memorandum on the taxing powers of the European Union*, EC Tax Review, 2002, p.121 and Isenbaert, M., *The Contemporary Meaning of “Sovereignty” in the Supranational Context of the EC as Applied to the Income Tax Case Law of the ECJ*, EC Tax Review, 2009, p. 267.

¹²⁷ Articles 110-118 TFEU and Isenbaert, M., *EC Law and the Sovereignty of the Member States in Direct Taxation*, Catholic University of Leuven, 2008, p. 98.

¹²⁸ See for ex. C-501/00, *Spain v Commission*, EU:C:2004:438, para. 123, and C-417/10, *3M Italia*, EU:C:2012:184, para. 25 and C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*, EU:C:2006:713, para. 20.

¹²⁹ C-298/05, *Columbus Container Service BVBA*, EU:C:2007:754, para. 51.

¹³⁰ See chapter 7 TFEU.

¹³¹ Article 3(b) TFEU and articles 116-117 TFEU.

¹³² Szudoczky, R., *The sources of EU law and their relationships: Lessons for the field of taxation*, IBDF, 2014, p. 727 and Wattel P.J., *European Tax Law*, Wolters Kluwer, 2018, p. 11.

¹³³ Article 116 TFEU.

¹³⁴ Article 5(1) TEU.

¹³⁵ As in article 2(6) TFEU and 5(2) TEU.

¹³⁶ T-131/16 and T-263/16, *Belgium v Commission*, EU:T:2019:91, para. 55 & 59.

within the scope of the State aid rules. Therefore the Member States need ensure that they do not exercise their competence in conflict with the State aid rules.¹³⁷ The CJEU confirmed that the Commission carries the responsibility to uphold article 107(1) TFEU and therefore the Commission cannot be accused of overstepping its competence when examining compliance with article 107(1) TFEU.¹³⁸

The result of the EU lacking direct taxing powers but has the aim to achieve market integration and fair competition, limits the CJEU to enforcing negative harmonisation on the basis of the Treaties.¹³⁹ Both the State aid rules, as a part of competition law, and the free movement provisions, are a part of EU regulations that lay the foundation for an undistorted system in the internal market.¹⁴⁰ State aid rules and the free-movement rules, are negative integration rules meaning they prohibit national measures that come into conflict with cross-border movement and free competition.¹⁴¹

In the balancing act between the Member States' fiscal sovereignty on the one side, and the EU objective of market integration through State aid prohibition, on the other side finding the point of equilibrium presents challenges. *Jaeger*, argues that when the Commission State aid decision have a norm creating effect that shapes tax policies, the Commission has exceeded its authority, highlighting that State aid is a tool to be used for correcting competitive and distortive effects.¹⁴² Lyal, deduces that the Commission has a duty to examine tax rulings so that they do not comprise illegal State aid, however, it should not be the objective of the Commission to enforce its own ideas of what an ideal tax system should look like on the Member States.¹⁴³

3.4 State aid, the division of competence and the *principle of equality*.

Fiscal sovereignty and the division of competence between the EU and the Member States may be recognised in State aid by the requirement of allowing a selective advantage to be justified by the nature or the overall structure of the tax system the tax measure is part of.¹⁴⁴ When evaluating the presence of State aid, the evaluation should focus on if the national measures provide for similar treatment to objectively comparable situation, and if not, if the difference in treatment may be justified. *Szudoczky*, claims this to be an expression of the principle of equality.¹⁴⁵

¹³⁷ T-131/16 and T-263/16, *Belgium v Commission*, EU:T:2019:91, para. 61-64.

¹³⁸ T-131/16 and T-263/16, *Belgium v Commission*, EU:T:2019:91, para. 67-70.

¹³⁹ Vanistendael, F., *Memorandum on the taxing powers of the European Union*, EC Tax Review, 2002, p. 122-123.

¹⁴⁰ Article 3 TEU, Protocol (No 27) on the internal market and competition, article 26 TFEU and Szudoczky, R., *Convergence of the Analysis of National Tax Measures under the EU State Aid Rules and the Fundamental Freedoms*, European State Aid Law Quarterly, 2016, p. 58.

¹⁴¹ Wattel, P.J., *Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters*, World Tax Journal, 2013, p. 129.

¹⁴² Jaeger, T., *Tax Incentives Under State Aid Law: A Competition Law perspective*, as in as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p. 44.

¹⁴³ Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int'l L.J. 1017 (2015), p. 1042.

¹⁴⁴ C-487/06 P, *British Aggregates Association v Commission of the European Communities and United Kingdom*, EU:C:2008:757, para. 82-83.

¹⁴⁵ Szudoczky, R., *The Sources of EU Law and Their Relationships: Lessons for the Field of Taxation*, IBDF, 2014, p. 728.

The principle of equality is a vital principle in western jurisprudence.¹⁴⁶ Expressed in the Charter of Fundamental rights of the European Union,¹⁴⁷ TEU¹⁴⁸ and TFEU,¹⁴⁹ the EU declares the aim of combating discrimination, promoting and protecting equality.¹⁵⁰ In the jurisprudence, the principle of equality requires rules that are universally applicable. Likes are to be treated alike, and for there to be a difference in treatment, there needs to be a justification.¹⁵¹ In the CJEU case law the principle of equality, takes the shape of a comparability test. In the CJEU case law concerning the fundamental freedoms in the EU, the principle of equality is expressed through the discrimination test that the CJEU applies. In State aid law, the principle of equality is expressed through the requirement of a benchmark reference system. The challenge of the principle of equality tends to be defining which situations or circumstances are in fact comparable and what should the criteria be for identifying comparable situations. The CJEU in assessing comparability refer to objective differences. Pålsson argues that despite the wording used by the CJEU, the criteria to establish comparability are not objective.¹⁵² Instead it is a system of subjective choices that rests on social construction. Pålsson exemplifies this viewpoint by referring to how the CJEU has chosen to view residents and non-residents of a Member State, as not to be in comparable circumstances.¹⁵³ Pålsson argues, that this is a subjective choice with objectively verifiable criteria that is natural when constructing comparability.¹⁵⁴

3.5 Conclusion

Fiscal sovereignty is a principle and not a rule. As a principle, sovereignty is a variable dependent on the circumstances which it is surrounded by. Fiscal sovereignty is currently manifested in a two-fold manner. Firstly, through the agreements, alliances and Unions the States are free to enter. These agreements, alliances and Unions set the limits to States sovereignty. Secondly, fiscal sovereignty is manifested through the freedom that States enjoy in structuring and planning their own tax systems. Enabling States to establish the level of welfare of their choosing, to fund their government expenditure and to encourage, or limit, the behaviour of their citizens. States enjoy the competence to decide the criteria and level of taxation within their taxing jurisdiction, it is also the States prerogative to decide which principles and rules should govern how taxes should be collected.

When a State joins the EU, that State surrenders, in part, its sovereignty within given policy fields. Hence, the Member States and the EU enjoy supremacy in parallel according to their respective objectives and functions. The same objectives and functions also confine both the

¹⁴⁶ Pålsson, R., *Equality in Taxation: Reflections on the Social Construction of Comparability in Tax Law*, as in Brokelind, C., (ed.), *Principle of law: Function, Status and Impact in EU Tax Law*, IBFD, 2014, Chapter 7.2.

¹⁴⁷ Article 20 and 21 of the EU Charter of fundamental rights.

¹⁴⁸ Article 2 TEU.

¹⁴⁹ Article 18 TFEU.

¹⁵⁰ Article 2(3) TEU.

¹⁵¹ Pålsson, R., *Equality in Taxation: Reflections on the Social Construction of Comparability in Tax Law*, as in Brokelind, C., (ed.), *Principle of law: Function, Status and Impact in EU Tax Law*, IBFD, 2014, Chapter 7.2.

¹⁵² Pålsson, R., *Equality in Taxation: Reflections on the Social Construction of Comparability in Tax Law*, as in Brokelind, C., (ed.), *Principle of law: Function, Status and Impact in EU Tax Law*, IBFD, 2014, Chapter 7.2.

¹⁵³ See for ex C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker*, EU:C:1995:31, para. 34.

¹⁵⁴ Pålsson, R., *Equality in Taxation: Reflections on the Social Construction of Comparability in Tax Law*, as in Brokelind, C., (ed.), *Principle of law: Function, Status and Impact in EU Tax Law*, IBFD, 2014, Chapter 7.2.

Member States and the EU, limiting their discretion to act to the boundaries of their respective policy fields. The EU holds supremacy in competition law. This entails the function and objective of ensuring a level playing field for undertakings. A level playing field in State aid requires the effectuation of the principle of equality *i.e.* the similar treatment of undertakings in comparable situations. To reach the objective of a level playing field and an undistorted internal market, the EU has full competence. That includes prohibiting the tax legislation of a Member State, if it satisfies the criteria of illegal State aid in article 107(1) TFEU. However, what constitutes similar treatment, and which situations should be considered comparable or equal, is defined by subjective choices that are objectively verifiable. In direct tax law, being a Member State competence, these subjective choices and the setting of objectively verifiable criteria fall within the Member State competence. The Member States have the function and objective of creating a system of direct taxation but must do so in accordance with EU law. Any tax treatment by a Member State that risks distorting competition by providing a selective advantage to an undertaking and not to other undertakings in similar and factual situations, may be deemed illegal under the State aid rules. In conclusion, the division of competence within the EU, and the implications of fiscal sovereignty of the Member States, mean that EU has the functional responsibility of achieving the aim of an undistorted internal market. The competence the EU has in direct tax law, using the State aid article of 107(1) TFEU, is limited to that of negative integration *i.e.* prohibiting tax treatment that distorts competition.

4 How has State aid been applied by the Commission in its recent decision with relation to fiscal sovereignty.

4.1 The recent Commission decisions.

The Commission decisions on Fiat and Starbucks were the first Commission decisions to be issued, followed by the Commission decisions on Apple, Belgian excess profit exemption scheme, Amazon and Engie. The Kingdom of Belgium appeal¹⁵⁵ on the Belgian excess profit exemption scheme, has since reached the tribunal, where the Belgian pleads where upheld.¹⁵⁶ Pending are the Commission's investigations on State aid to Ikea¹⁵⁷ and Nike.¹⁵⁸ All of the Commission decisions, so far, concern tax rulings that the Member States have provided MNEs.¹⁵⁹ Whereas Fiat, Starbucks¹⁶⁰ and Amazon¹⁶¹ concern transfer pricing methodology, Engie concerns qualification issues of financial structures, and Apple concerns profit allocation methods¹⁶² as well as qualification issues of residents.¹⁶³ The Commission decision on the

¹⁵⁵ T-131/16, *Belgium v Commission*, EU:T:2019:91.

¹⁵⁶ T-131/16, *Belgium v Commission*, EU:T:2019:91. para. 136.

¹⁵⁷ European Commission Press release: *State Aid: Commission opens in-depth investigation into the Netherlands' tax treatment of Inter IKEA*, (18 Dec. 2017).

¹⁵⁸ European Commission Press release: *State Aid: Commission opens in-depth investigation into tax treatment of Nike in the Netherlands*, (10 Jan. 2019).

¹⁵⁹ Commission Decision SA.38375 Fiat, p. 52, Commission Decision SA.38374 Starbucks., p. 40, Commission Decision SA.38373 Apple, p. 145, Commission Decision SA.38944 Amazon, p.121, Commission Decision SA.44888 Engie p.23,

¹⁶⁰ Commission Decision SA.38374 Starbucks, p. 46.

¹⁶¹ Commission Decision SA.38944 Amazon, p. 129.

¹⁶² Commission Decision SA.38373 Apple, p. 148-150.

¹⁶³ Commission Decision SA.44888 Engie p. 93.

Belgian excess profit exemption scheme deviates as the Commission examines an aid scheme and not individual aid. The Commission's issued decisions are binding on the Member States they are addressed to.¹⁶⁴

There are two basic arguments that occur in all the mentioned Commission decisions. The first, is the reference system used to establish a selective advantage and the second, is the legal basis for the *arm's length principle*.

4.2 The reference system used in the Commission decisions.

The three-step analysis is used by the Commission to determine selectivity by first establishing the normal or benchmark system and secondly by establishing a derogation from that system.¹⁶⁵ Although in both the Apple and Amazon decisions the Commission states the three-step analysis to be unnecessary as is it a question of individual aid and thus selective per se. In all the Commission decisions' the Commission considers the reference system to be the general corporate income tax system of the respective Member State.¹⁶⁶

Using slightly different terminology in the decisions, the Commission gives different reasons as to why the general corporate income tax system is the right choice of reference system. In Fiat the Commission reasons the general corporate income tax system to be appropriate as stand-alone companies and group companies need to be put on equal footing.¹⁶⁷ Whereas in Starbucks the Commission deems the Dutch corporate income tax system to be appropriate viewed in light of the intrinsic objective of the Dutch corporate income tax system, stand-alone and group companies should be considered to be in similar factual and legal situation.¹⁶⁸ In Apple, Amazon and the Belgian excess profit exemption scheme, the reason to choose the ordinary rules of taxation of corporate profit is the intrinsic objective of profit on all companies subject to tax in Ireland, Luxembourg and Belgium respectively.¹⁶⁹ In the Commission decision in Engie, the Commission argues that the choice of reference system is the ordinary rules of taxation of corporate income in Luxembourg as this is consistent with CJEU case law. The Commission furthers its reasoning by arguing that limiting the reference framework to the *lex specialis* of the Member State, would be dependent on the Member State having implemented specific tax rules. Using *lex specialis* rather than *lex generalis* would enable the Member States to, through regulatory technique, circumvent State aid control by implementing rules that grant tax advantages to MNEs and then claiming there to be no derogation from the applicable rules.¹⁷⁰ Referring to the *principle of legality*, Luxembourg argues exactly so. Stating that, a measure needs to be written in law otherwise it cannot be subject to taxation and if a measure

¹⁶⁴ Article 288 TFEU.

¹⁶⁵ Commission Decision SA.38375 Fiat, p. 192, Commission Decision SA.38374 Starbucks, p. 230, Commission Decision SA.38373 Apple, p. 224, Commission Decision SA.38944 Amazon, p.339-400, Commission decision Belgian Excess profit scheme, p. 119, Commission Decision SA.44888 Engie, p. 167-170.

¹⁶⁶ Commission Decision SA.38375 Fiat, p. 194, Commission Decision SA.38374 Starbucks, p. 232, Commission decision in Apple, p.228, Commission Decision SA.38944 Amazon, p. 587-599, Commission Decision SA.44888 Engie, p. 170, Commission decision Belgian Excess profit scheme, p. 121.

¹⁶⁷ Commission Decision SA.38375 Fiat, p. 86 & p. 194.

¹⁶⁸ Commission Decision SA.38374 Starbucks, p. 244.

¹⁶⁹ Commission Decision SA.38373 Apple, p. 228, Commission decision in Amazon p. 588 and Commission decision Belgian Excess profit scheme, p. 120-121.

¹⁷⁰ Commission Decision SA.44888 Engie, p. 179-187.

complies with national law, how can a measure derogate from it.¹⁷¹ In the Engie decision the Commission constructs an additional analysis, checking if the tax measure would constitute a derogation in relation to the reference system consisting of companies that may apply the Luxembourg law on participation exemption and taxation of profit distributions.¹⁷² As rules may lead to double taxation, participation exemption rules may apply to both profit distribution and capital gains originating from the eligible participations. The objective of the Luxembourg rules is preventing double economic taxation.¹⁷³ Arguing that Engie is in the same legal and factual situation as all other companies receiving income from participations¹⁷⁴ the Commission argues that the treatment nevertheless constitutes a derogation from the reference system the tax ruling allows for an exemption and a deduction that improves Engie's financial situation. The Commission states that to permit an interpretation of the Luxembourg provisions that would allow Engie to easily circumvent the law would be against the objective of the Luxembourg tax system as well as the objective of avoiding double taxation. The fact that it is open to other undertakings to do the same, does not alter selectivity.¹⁷⁵

In all the Commission decisions' the Member States argue that the Commission's reference system of choice is, in their opinions, incorrect. The correct reference system should be either relevant *lex specialis* or the jurisprudence of the Member State.¹⁷⁶ In Fiat, Starbuck and Amazon the Member States all argue that the MNEs should be compared to other group companies as it is only other group companies that need to use the arm's length principle to allocate profits.¹⁷⁷ Whereas in Apple, Ireland argues that residents and non-residents are in different situations as residents are taxed on worldwide income and non-residents only on sourced income.¹⁷⁸

To conclude, regardless of the Commission's choice of wording, it can be concluded to two issues. First, the Commission considers it unessential whether it is an independent company or an entity that is part of an MNE. The companies are in comparable factual and legal situations when assessing their liability to pay corporate tax on income. Secondly, the reference system is the Member State corporate tax system as *lex generalis* and not the jurisprudence or *lex specialis* particulars of the Member State corporate tax system.

4.3 The arm's length principle inherent in Article 107(1) TFEU.

In the absence of transactions where terms have been dictated by market conditions, the arm's length principle comes into play. This gives rise to the second legal argument central in the Commission decisions, which is, if the arm's length principle is inherent in article 107(1) TFEU and if so, is it derived from a general principle of equal treatment in taxation.

¹⁷¹ Commission Decision SA.44888 Engie, p. 180 and p. 194.

¹⁷² Commission Decision SA.44888 Engie, p. 200.

¹⁷³ Commission Decision SA.44888 Engie, p. 116.

¹⁷⁴ Commission Decision SA.44888 Engie, p. 202-203.

¹⁷⁵ Commission Decision SA.44888 Engie, p. 218-226.

¹⁷⁶ Commission Decision SA.38375 Fiat, p. 210, Commission Decision SA.38374 Starbucks, p. 87 & p. 181-182, Commission Decision SA.38373 Apple, p. 237, Commission Decision SA.38944 Amazon, p. 293-294, Commission Decision SA.44888 Engie, p. 177 & p.200 and Commission Decision SA.37667 Belgium excess profit exemption scheme, p. 121 & p. 123-126.

¹⁷⁷ Commission Decision SA.38375 Fiat, p. 210, Commission Decision SA.38374 Starbucks, p. 248, Commission Decision SA.38944 Amazon, p. 295

¹⁷⁸ Commission Decision SA.38373 Apple, p. 237.

The Commission affirms the use of the arm's length principle based on two different legal grounds. The first legal ground is the use of the arm's length principle as illustrated in the Fiat, Starbucks and Belgian excess profit exemption scheme decisions.

In Fiat the Commission declares, that regardless if the arm's length principle is incorporated in the national legal system, the arm's length principle is to be used to assess selectivity in a tax measure as the arm's length principle is an expression of the principle of equal treatment, thus forming a part of the Commission's State aid assessment as per article 107(1) TFEU. The method of calculation used by Luxembourg, does not give reliable approximation of the arm's length principle which results in a selective advantage.¹⁷⁹ In Starbucks the same legal argument is used. The arm's length principle is incorporated into Dutch tax law and the OECD Guidelines have been given direct application in Dutch tax legislation. As some of the OECD Guidelines are difficult to apply, a Decree has been issued to be used as an explanatory tool for Dutch interpretation of the OECD Guidelines.¹⁸⁰ The Netherlands submits that the challenged tax ruling is at arm's length. Stating that, transfer pricing is not an "exact science" and so the outcome of the tax ruling in Starbucks lies within the range of what is acceptable.¹⁸¹ In Fiat, Starbucks as well as the Belgian excess profit exemption scheme the Commission states that the arm's length principle used to assess State aid stems from the principle of equal treatment inherent article 107(1) TFEU and not the OECD Model Tax Convention. Hence, the Member States are bound by article 107(1) TFEU and not the OECD Model treaty.¹⁸² The Commission defends itself against the accusations that it has taken upon itself to interpret national law on behalf of the tax administration in the Starbucks-decision, by claiming that as per the OECD TP Guidelines, the aim of the arm's length principle is to find a reasonable estimate of the market-based outcome and if the method used by the tax administration does not provide for a reliable approximation, the tax ruling may grant a selective advantage.¹⁸³

The second legal argument can be illustrated by the Apple decision. In the Apple decision the Commission states that the arm's length principle is endorsed by the CJEU in *Kingdom of Belgium v Forum 187*¹⁸⁴ ASBL as a tool to assess whether a group company, compared to a stand-alone company, is the recipient of a selective advantages as per article 107(1) TFEU.¹⁸⁵ The Commission articulates that the non-binding OECD Model Tax convention is not given direct applicability, the OECD Model Tax convention merely functions as an interpretive guide from which deviations will only be a verification of the Commission findings.¹⁸⁶ The same legal base is used in the Amazon decision where the Commission further concludes that if the tax ruling fails to produce a reasonable estimate of an arm's length principle, an advantage is present.¹⁸⁷ The Commission states their arguments to be based on the arm's length principle as

¹⁷⁹ Commission Decision SA.38375 Fiat, p. 227-231.

¹⁸⁰ Commission Decision SA.38374 Starbucks, p. 87 & p. 181-182.

¹⁸¹ Commission Decision SA.38374 Starbucks, p. 162.

¹⁸² Commission Decision SA.38375 Fiat, p. 228-231, Commission Decision SA.38374 Starbucks, p. 264 and Commission decision SA.37667 Belgian Excess Profit Exemption Scheme, p. 150-151.

¹⁸³ Commission Decision SA.38374 Starbucks, p. 266-267.

¹⁸⁴ C-182/03 and C-217/03, *Kingdom of Belgium v Forum 187 ASBL*, EU:C:2006:416.

¹⁸⁵ Commission Decision SA.38373 Apple, p. 251-253.

¹⁸⁶ Commission Decision SA.38373 Apple, p. 255-257.

¹⁸⁷ Commission Decision SA.38944 Amazon, p. 404-406.

endorsed by CJEU case law of *Belgium and Forum 187 ASBL v Commission*.¹⁸⁸ Although explicitly stated in Apple and Amazon, the same CJEU case law can be found referenced in the footnotes in Starbucks, Belgian excess profit exemption scheme and Fiat to deduce the arm's length principle being inherent in article 107(1) TFEU.¹⁸⁹

4.3.1 The arm's length principle endorsed by the CJEU.

All the Commission decision either directly state that the arm's length principle is endorsed by the CJEU case law in *Belgium and Forum 187 ASBL v Commission* or reference the case in footnotes. The *Belgium and Forum 187 ASBL v Commission* case concerns the use of the *cost plus method* to establish transfer pricing between coordination centers. The Commission seems to find the case relevant predominately for two reasons. First, as a confirmation of that tax measures are not immune from being deemed illegal under the State aid rules in article 107(1) TFEU.¹⁹⁰ Secondly, as what is established in the case is that excluding certain costs which are necessary to obtain a correct cost plus calculation in a transfer pricing transaction confers a selective advantage as per the State aid definition in article 107(1) TFEU.^{191 192}

4.4 Qualification issues of Apple and Engie and untaxed profits.

4.4.1 Apple.

The Apple decision concerns the Irish rules that provide trading exceptions to companies incorporated in Ireland.¹⁹³ The trading exception rules are designed so that if a company is effectively controlled or managed outside of Ireland, the company is deemed not to be tax resident in Ireland, even though it has trading activity in Ireland and even though the company may not be deemed resident under another tax jurisdiction. Apple has affiliated companies in Ireland that make use of the trading exception. At the same time Apple does not fulfill the resident criteria in the U.S. or in any other tax jurisdiction and is as such resident nowhere.¹⁹⁴ As the Apple affiliates are qualified as non-residents, Ireland regards the profit allocation to be in line with the value creation by the branches located in Ireland.¹⁹⁵ Apple, being a non-resident is taxed only on source income in Ireland. This leaves the Apple profits not taxed in Ireland to be untaxed, ergo the biggest part of Apple's profits remains untaxed. If the Apple affiliated

¹⁸⁸ C-182/03 and C-217/03, *Belgium and Forum 187 ASBL v Commission*, EU:C:2006:416.

¹⁸⁹ Commission Decision SA.38944 Amazon, p. 629, Commission decision SA.37667 Belgian Excess Profit Exemption Scheme, p. 150, Commission Decision SA.38374 Starbucks, p. 259-261 and Commission Decision SA.38375 Fiat, p. 223-225.

¹⁹⁰ C-182/03 and C-217/03, *Belgium and Forum 187 ASBL v Commission*, EU:C:2006:416, para. 81, Commission Decision SA.38375 Fiat, p. 228, Commission Decision SA.38374 Starbucks, p. 264, Commission Decision SA.38373 Apple, p. 249. Commission Decision SA.38944 Amazon, p. 405, Commission decision SA.37667 Belgian Excess Profit Exemption Scheme, p. 150 and Commission Decision SA.44888 Engie, p. 347.

¹⁹¹ C-182/03 and C-217/03, *Kingdom of Belgium and Forum 187 ASBL v Commission of the European Communities*, EU:C:2006:416, para. 1 and para. 95-97, Commission Decision SA.38375 Fiat, p. 223, Commission Decision SA.38374 Starbucks, p. 259, Commission Decision SA.38373 Apple, p. 249 and Commission decision SA.37667 Belgian Excess Profit Exemption Scheme, p.121 and p. 146.

¹⁹² This is not mentioned in the Commission decision in Engie.

¹⁹³ Anthony Ting argues that Apples tax structure achieves double non-taxation due to a combined effect of differences in qualification between Ireland and the U.S, Transfer pricing rules on intangibles, the U.S. controlled foreign company rules, the U.S. check-the-box regime and low-tax jurisdiction. Ting, A., *iTax – Apple's International Tax Structure and the Double Non-Taxation Issue*, p. 46.

¹⁹⁴ Commission Decision SA.38373 Apple, p. 49-52.

¹⁹⁵ Commission Decision SA.38373 Apple, p. 159.

companies would have been deemed resident in Ireland, they would have been taxed on their worldwide profit.¹⁹⁶

4.4.2 Engie.

In the Commission decision in Engie, two tax rulings issued by Luxembourg tax office are under scrutiny.¹⁹⁷ The Engie decision, in comparison to the other recent Commission decisions, differentiates itself as the decision covers a purely national situation. All the companies involved in the different tax transactions are resident in Luxembourg for tax purposes.¹⁹⁸ However, as the Engie group is active within the energy industry and its companies operate in several markets the Commission concludes that the favorable treatment given by the Luxembourg tax authorities will affect intra-Union trade.¹⁹⁹ Additionally, contrary to the tax rulings in Starbucks, Amazon and Fiat, where the transfer pricing method used to establish a plausible arm's length outcome is the principle worry, the Engie decision concerns qualifications of a transfer of assets financed by an interest free convertible loan labelled ZORA.²⁰⁰ The ZORA is a loan paid by shares or ZORA accretions. The payment of the ZORA is qualified as interest and as such deductible at the level of the receiver of the ZORA.²⁰¹ The income from payment for the ZORA, through ZORA accretions or shares, is labeled as participation and can therefore, under the Luxembourg participation exemption rules, be exempt from taxation. The conundrum is that exactly what constitutes a participation is not defined by Luxembourg law.²⁰² Referring to the principle of legality, Luxembourg argues that it cannot tax. The Commission states that the argument by Luxembourg, which is that the non-taxation is the result of a lacuna in law, cannot hold as it would render the State aid rules ineffective.²⁰³ ²⁰⁴ The Commission further states that mismatches as a result of different qualifications may occur between different taxing jurisdictions. However, for this type of mismatches to occur in a purely internal situation cannot be permissible as it would be inconsistent with the EU and OECD efforts of combating tax avoidance.²⁰⁵ The result of a non-taxable income is considered by the Commission to be contrary to the general objective of the Luxembourg law, resulting in discrimination and selectivity towards stand-alone companies who are in similar factual and legal circumstances.²⁰⁶ The objective of the Luxembourg rules is to eliminate economic double taxation of distributed dividend or capital gains²⁰⁷ however the Luxembourg rules are not questioned by the Commission. Only the application of the rules under the tax rulings.²⁰⁸

¹⁹⁶ Commission Decision SA.38373 Apple, p. 72.

¹⁹⁷ Commission Decision SA.44888 Engie, p. 23.

¹⁹⁸ Commission Decision SA.44888 Engie, p. 222-223.

¹⁹⁹ Commission Decision SA.44888 Engie, p. 158.

²⁰⁰ Commission Decision SA.44888 Engie, p. 2

²⁰¹ Commission Decision SA.44888 Engie, p. 93.

²⁰² Commission Decision SA.44888 Engie, p. 202.

²⁰³ Commission Decision SA.44888 Engie, p. 183-188 and p. 194-195.

²⁰⁴ I am assuming that by a lacuna Luxembourg and the Commission are referring to the concept of participation being undefined in Luxembourg law. See Commission Decision SA.44888 Engie p. 202.

²⁰⁵ Commission Decision SA.44888 Engie, p.223.

²⁰⁶ Commission Decision SA.44888 Engie, p. 92(3), p. 95-97, p.166, p.198 and p. 256.

²⁰⁷ Commission Decision SA.44888 Engie, p. 203.

²⁰⁸ Commission Decision SA.44888 Engie, p. 166 and p. 276.

4.4.3 The Belgian excess profit exemption scheme.

The Belgian excess profit exemption scheme contains no qualification issue, however similarly to the Apple decision, it contains unallocated untaxed profits. Under the Belgian scheme, MNEs can reduce their tax base in Belgium by deducting excess profit from their actual recorded profit. It is a two-step approach. First, the arm's length profits are determined, based on the assumed average profit of a stand-alone company in comparable circumstances. In a second step, the assumed profit is deducted from the actual profit. The excess profit is then exempt from Belgian taxation. The Belgian authorities defend their approach by stating that only what is at arm's length should be taxed. What is in excess of arm's length is up to the MNEs to decide which foreign entity tax base it should be allocated to.²⁰⁹ The Commission furthers the analysis and deems the Belgian excess profit exemption rules to constitute a derogation from the Belgian corporate income tax system which leads to unequal treatment.²¹⁰ The scheme is selective as it is only available to MNEs, it requires an advanced pricing agreement (APA) which in turn requires a change of situation as the need for a new APA only arises when an MNE has a change of circumstances. To react to a change of circumstance and initiate a request for an APA also provides for a *de facto* selective advantage as it is, according to the Commission, a too cumbersome procedure for smaller companies.²¹¹ To evaluate if there is an advantage the Commission investigates if the methodology that the Belgian regime uses truly establishes a market based outcome. The Commission concludes that the Belgian scheme constitutes illegal State aid as the methodology that the Belgian authorities apply deviates from the methodology that arrives at a reliable market-based outcome.²¹² Belgium claims that the challenged scheme can be justified as a measure to avoid double taxation, whereas the Commission argues that the Belgian legislation goes beyond what is necessary and proportionate to fulfill that aim.²¹³

4.5 Other issues.

4.5.1 The anti-avoidance rules in Engie.

In the Engie-decision the Commission investigates if the criteria for illegal State aid is fulfilled as the Commission believes that the Luxembourg tax authorities should not have issued the tax ruling as the Luxembourg rules on abuse of law can be applied to the arrangement.²¹⁴ The Commission states that the object of the corporate income tax system is to tax corporate profits arising in Luxembourg, and the object of the anti-avoidance rules is to hinder circumvention of the corporate income tax system.²¹⁵ As illustrated in figure 1, the tax rulings in Engie concern the following circular arrangement.

²⁰⁹ Commission Decision SA.37667 Belgium excess profit exemption scheme, p. 13-15, p.39 and p. 81.

²¹⁰ Commission Decision SA.37667 Belgium excess profit exemption scheme, p. 130-133.

²¹¹ Commission Decision SA.37667 Belgium excess profit exemption scheme, p. 138-141.

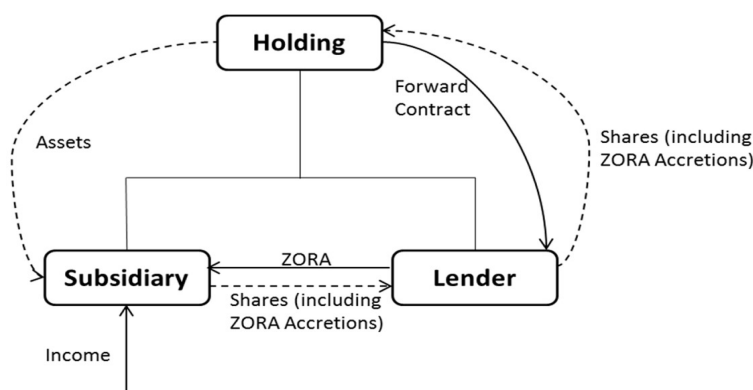
²¹² Commission Decision SA.37667 Belgium excess profit exemption scheme, p. 170.

²¹³ Commission Decision SA.37667 Belgium excess profit exemption scheme, p. 175.

²¹⁴ Commission Decision SA.44888 Engie, p.289 and p.299.

²¹⁵ Commission decision SA.44888 Engie, p.290-291.

Figure 1. Illustration of the structure set up in the contested tax ruling in the Engie-decision.²¹⁶



The transactions are described below.

1. Transfer of assets from the Holding company to the subsidiary in Luxembourg.
2. The transfer is financed by an interest free convertible loan *i.e.* ZORA.²¹⁷ The ZORA is provided by another intra-group company, the Lender.
3. The expense of the ZORA is paid by the Subsidiary in shares or ZORA accretions. The ZORA is interest free but a bonus consisting of almost all the profits that of the Subsidiary will also be paid.²¹⁸
4. The ZORA is in turn financed, by a loan to the Lender from the Holding.
5. In a forward contract between the Lender and the Holding the Zora Accretions originating from the Subsidiary, are forwarded to the Holding as payment for the Lenders loan from the Holding.

The Luxembourg corporate tax system participation exemption rules have the objective of eliminating economic double taxation. The above transactions provide for the below outcome.

1. The qualification of the ZORA results in, the ZORA Accretions being labeled as interest and therefore deductible from the taxable base of the Subsidiary.²¹⁹
2. Whereas for the Holding, being the receiver of the ZORA Accretions, the income qualifies as a participation and can therefore, under the Luxembourg participation exemption rules, be exempt from taxation.

The Commission claims that Engie's tax structure meets the criteria as set out in the Luxembourg general anti-abuse rules (GAAR). The tax rulings were therefore issued in error by the Luxembourg tax authorities.²²⁰ The error of the issued tax rulings thus provides for a selective advantage for Engie in comparison to other undertakings resulting in the required conditions for fulfillment of article 107(1) TFEU and the finding of illegal State aid.²²¹

²¹⁶ Commission decision SA.44888 Engie, figure 1.

²¹⁷ Commission decision SA.44888 Engie, p. 2.

²¹⁸ Commission decision SA.44888 Engie, p.24.

²¹⁹ Commission decision SA.44888 Engie, p. 93.

²²⁰ Commission decision SA.44888 Engie, p. 294-300.

²²¹ Commission decision SA.44888 Engie p. 311-313.

4.5.2 The Belgian excess profit exemption scheme appeal.

The appeal of the Belgian excess profit exemption scheme-decision is the only appeal that has so far reached the CJEU. Unfortunately, the appeal judgement does not provide much guidance as to how the CJEU may decide in future judgments. The Commission decision is annulled, based on that the Commission incorrectly classified the Belgian excess profit exemption system to be an aid scheme. The definition of an aid scheme entails an act that does not require any further implementing measures.²²² Contrary to the Commissions argument, that the Belgian tax authorities only technically administers the scheme at issue, the CJEU finds that the Belgian tax authorities, in the second step of the two-step assessment, enjoy a margin of discretion and make decisions on a case-by-case basis as to whether a down-ward or up-ward adjustment on profits should be made.²²³ The CJEU concludes a second implementing measure to be undertaken by the Belgian tax authorities and therefore no aid scheme is present.²²⁴ The decision has been appealed.²²⁵

5 Analysis.

5.1 Introduction.

The EU and the Commission are sovereign in the area of competition law. Achieving the with aim of an internal market free from competitive distortion rests within the EU competence. The Commission carries the responsibility to investigate and ensure that the Member States adhere to the State aid rules. The Member States cannot, by referring to fiscal sovereignty and the principle of conferral, stop the Commission from investigating whether the Member States national tax legislation is compliant with the State aid rules. The Commission decisions are binding to whom they are addressed to. However, all the recent Commission decisions discussed in this thesis have been appealed by the Member States to the CJEU. The Belgian excess profit exemption scheme decision was overturned based on a technicality, leaving no indication as to how the CJEU will finally decide the choice of reference system, the arm's length principle being inherent in article 107(1) TFEU and an expression of the principle of equality, qualification issue within the same tax jurisdiction and in different taxing jurisdictions or MNE profits that are untaxed. As show in Chapter 2 of this thesis, State aid law is undergoing an evolution and so what the outcome of the Commission decisions will be after being scrutinized by the CJEU, is uncertain. Nevertheless, in the basic legal arguments of the Commission decisions, there are areas where it can be questioned to what extent the Commission is acting in accordance with the State aid rules and within the limits of their sovereignty/competence or if the Commission is encroaching on the Member States' fiscal sovereignty.

²²² Council regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (codification). Article 1(d).

²²³ T-131/16 and T-263/16, *Belgium v Commission*, EU:T:2019:91, para. 102-111.

²²⁴ T-131/16 and T-263/16, *Belgium v Commission*, EU:T:2019:91, para. 120 & 135.

²²⁵ Appeal case before the Court of Justice C-337/19 P.

5.2 Analysis of the reference system and comparability of group and stand-alone companies.

In all the Commission decisions the reference system used to measure the derogations, is the general corporate income tax system of the Member States. By using the whole corporate income tax system as a reference system all undertakings, regardless if they are part of a group entity or stand-alone companies, are deemed to be in similar factual and legal situation viewed in light of the objective of the corporate income tax system. As such they are comparable with each other. The CJEU has in the *Paint Graphos* case validated the use of the general corporate income tax system as the benchmark system. Although the use of a wide reference system has been further validated by CJEU case law after *Paint Graphos*, the CJEU case law is not consistent.²²⁶ The Commission builds on the arguments in support of its choice of reference system by claiming that choosing a narrower reference system may open for regulatory technique to be used by the Member States that may render the State aid provisions ineffective, as in the Gibraltar case.²²⁷ Arguing from a competition law point of view, all economic operators conducting economic activity within the internal market are placed in one category and assessed to see if competition is distorted through tax measures that have the effect of producing unjustified, selective and beneficial treatment. If the CJEU agrees with the Commission choice of reference system to be the corporate income tax system and the fundamental objective to be the taxation of corporate profits, the Commission has acquired effective way of overseeing the Member States corporate tax systems. Wattel argues that the broad reference system will make it necessary for the Member States to demonstrate and justify why a specific group of undertakings tax treatment deserves to be different from others.²²⁸ Although, ideal from the Commission's functional aim of ensuring a level playing field, from a Member State and fiscal sovereignty point of view it creates legal uncertainty for both the legislator as well as the taxpayer as it becomes unclear who has the true authority to decide the design of the tax system. From fiscal sovereignty perspective, the functional objective of creating a system of taxation that raises revenue within the tax jurisdiction becomes limited. Wattel argues that the political decisions on how to tax becomes an EU competence rather than a Member State one. In fact, what is left for the Member States to freely decide, without needing to justify this to the Commission, is changing the corporate income tax rate.²²⁹ Luja cautions the use of a too wide scope of the State aid rules, as not only may it limit the Member States' fiscal sovereignty, it may impede the Member States from constructing tax systems that are competitive against third countries.²³⁰ Luja further questions if group companies and stand-alone companies really can be placed into similar and factual legal situations considering the conditions in a normal market.²³¹ Galendi Júnior opinions as Luja, concluding that transaction

²²⁶ Ismer, R., & Piotrowski, S., *The Selectivity of Tax Measures: A Tale of Two Consistencies*, Intertax, 2015, p. 561 and Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int'l L.J. 1017 (2015), p. 1033.

²²⁷ Although the outcome of the Gibraltar case was that the CJEU judged there to be illegal State aid.

²²⁸ Wattel, P.J., *Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters*, World Tax Journal, Feb 2013, p. 134.

²²⁹ See for ex. Wattel, P.J., *Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters*, World Tax Journal, Feb 2013, p. 134.

²³⁰ Luja, R., H.C., *(Re)shaping Fiscal State Aid: Selected Recent cases and Their Impact*, Intertax, 2012, p. 131.

²³¹ Luja, R., H.C., *Do State Aid Rule Still Allow European Union Member State to Claim Fiscal Sovereignty?*, EC Tax Review, 2016, p. 323 and Luja, R., *Just a Notion of Aid: How (Not) to Create a Fiscal State Aid Doctrine*, Intertax, 2016, p. 789.

that stand-alone companies undertake may result in gains that do not occur between intra-group companies, hence there is an inherent flaw in the arm's length principle.²³² Luja and Galendi Júnior positions, prove at the very least, that there are different arguments as to whether stand-alone companies and group companies are suitably comparable or not.

5.3 Analysis of the arm's length principle in 107(1) TFEU.

The Commission's line of reasoning in the decisions, concerning the arm's length principle, rests on two legal claims.

One being, the use of the arm's length principle as part of the State aid assessment as it stems from CJEU case law. The CJEU judgement of *Belgium and Forum 187 ASBL v Commission*, does not state that the arm's length principle is part of the State aid assessment nor that it is a required method for the Member States to use.²³³ Wattel considers the CJEU case law that the Commission leans on is inconclusive.²³⁴

The other legal claim is, that the aim of the arm's length principle is to establish a reasonable estimate of transactions between related companies. As such the arm's length principle is an expression of the principle of equal treatment and forms part of the selectivity assessment of article 107(1) TFEU. According to Pålsson, the principle of equality consists of objectively verifiable parameters used to identify the subjective definition of what should be considered equal.²³⁵ The question is if it is the Union's subjective notion of equality in competition law, or the Member States notion of equality with regards to fiscal sovereignty expressed through the allocation of taxing rights. Wattel advocates that the arm's length principle in State aid law rather should be called the *level playing field principle* as it is a measure of competition and not tax allocation.²³⁶

Disregarding, if it is the arm's length principle derived from the principle of equality inherent to article 107(1) TFEU or the arm's length principle validated by CJEU case law, the OECD guidelines have, according to the Commission, been used to verify that the tax treatment achieves a reliable approximation of what is arm's length. The Commission confirms this view, by stating that as the OECD TP guidelines embodies the international consensus on how to establish a reliable approximation of market conditions. Using the OECD TP guidelines will unlikely result in the finding of illegal State aid.²³⁷ Regardless, if the arm's length principle is part of national legislation or not. Both Wattel and Galendi Júnior concludes that the Commission seems to have construed a European autonomous arm's length principle. Galendi Júnior further reasons that decisions made by the Commission, that dictate how the Member States tax policies should be configured to ascertain a level playing field indicates the existence of a supranational reference system. Whereas Wattel argues that the Commission view of the arm's length principle in State aid should be viewed as a measure to block the unequal treatment

²³² Galendi Júnior, R.A, *State aid and Transfer Pricing: The Inherent Flaw Under a Supranational Reference System*, Intertax, 2018, p. 995.

²³³ C-182/03 and C-217/03, *Belgium and Forum 187 ASBL v Commission*, EU:C:2006:416.

²³⁴ Wattel, P.J., *Stateless Income, State Aid and the (Which?) Arm's Length Principle*, Intertax, 2016, p. 793-794.

²³⁵ See Chapter 3.4 of this thesis.

²³⁶ Wattel, P.J., *Stateless Income, State Aid and the (Which?) Arm's Length Principle*, Intertax, 2016, p. 792.

²³⁷ Commission notice in the notion of State aid as in, p. 173.

of undertakings in comparable factual and legal situations.²³⁸ Lyal reasons the OECD guidelines to provide for recognized and general acceptable methods. When the OECD guidelines are applied, the choice of method can be challenged, but it is not the method that should come under State aid scrutiny but the individual tax ruling. If the method is not a generally recognized and acceptable method, regardless if it is part of the national legislation or not, and it does not reflect what is at arm's length, then the method may be subject to State aid scrutiny.²³⁹

The arguments, seen from a competition law perspective can be defended by reasoning that the Commission is fulfilling its functional objective of ensuring an internal market free from competition. Conjuring additional rights to obtain the given aim of ensuring a level playing field. From the fiscal sovereignty of the Member State perspective, the Commission seems to be creating tax policies which equates to creating tax norms and forcing positive integration in the area of direct taxation. According to Jaeger this is problematic as the Commission then encroaches on the Member States policy area and sovereignty in creating tax policies.²⁴⁰

Luja argues that the advantage of the Commission decisions is that the MNEs and the Member States need to ensure they are producing correct TP estimates²⁴¹ but questions if the policy making decisions really should be handed over to the CJEU. Luja problematizes what the standards of the arm's length principle would look like. Asking if the Member States would be allowed to design their own arm's length principle and what standards the Commission and the CJEU would then permit. If the CJEU endorses the Commission view on the arm's length principle in article 107(1) TFEU, will that involve standard settings of the arm's length principle. Luja signals that these decisions are political and ideological policy making standard, and the answer may depend on what ideology the CJEU judges are committed to. Are the judges fierce on cracking down on harmful tax competition or more protectionist towards the fiscal sovereignty and autonomy for the Member State.²⁴²

5.4 The analysis of the qualification issues in Apple and Engie and the untaxed profits.

In Ireland, Apple, being effectively managed outside of Ireland, can apply the Irish trading exemption rules, which results in Apple qualifying as a non-resident in Ireland. In the U.S. Apple also qualifies as non-resident as the U.S. defines corporate tax residency by place of incorporation.²⁴³ Whilst the legal ownership of intellectual property remains in the U.S. the economic rights to Apple's intellectual property is transferred to Ireland, the cost sharing agreement between them results in profits shifted to where they are taxed the least or not at all.²⁴⁴ As the qualification issue in the Apple decision is the result of a qualification mismatch

²³⁸ Wattel, P.J., *Stateless Income, State Aid and the (Which?) Arm's Length Principle*, Intertax, 2016, p.7 92 and Galendi Júnior, R.A, *State aid and Transfer Pricing: The Inherent Flaw Under a Supranational Reference System*, Intertax, 2018, p. 995.

²³⁹ Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int'l L.J. 1017 (2015), p. 1041.

²⁴⁰ Jaeger, T., *Tax Incentives Under State Aid Law: A Competition Law Perspective*, as in Richelle, I., Schön, W. & Traversa, E. (red.), *State Aid Law and Business Taxation*, Springer Berlin Heidelberg, 2016, p. 44 ff.

²⁴¹ Luja, R., H.C., *Do State Aid Rule Still Allow European Union Member State to Claim Fiscal Sovereignty?*, EC Tax Review, 2016, p. 323.

²⁴² Luja, R., *Just a Notion of Aid: How (Not) to Create a Fiscal State Aid Doctrine*, Intertax, 2016, p. 789.

²⁴³ Ting, A., *iTax – Apple's International Tax Structure and the Double Non-Taxation Issue*, British Tax Review, 2014, p. 46.

²⁴⁴ Ting, A., *iTax – Apple's International Tax Structure and the Double Non-Taxation Issue*, British Tax Review, 2014, p. 47-49.

between two States, and as such can not be imputable to only one State, it is disputable whether the criterion of “aid granted by a Member State or through State resources” in article 107(1) TFEU is satisfied. What responsibility does Ireland have in adjusting its tax legislation, so disparities caused by mismatches due to the difference in the Irish tax legislation and the tax legislation of another State, does not give rise to double non-taxation? The CJEU have on several occasions stated that it does not fall within the competence of EU law to resolve tax treatment that arises as a result of different tax jurisdictions exercising their fiscal sovereignty in parallel.²⁴⁵ Wattel argues, for the Apple decision to make sense, it needs to be seen from a competition law perspective. As from a competition law point of view, the Commission is enforcing the State aid rules with the aim of protecting a level playing field.²⁴⁶ Wattel’s line of reasoning does not reflect from the issue that the qualification issue in Apple stems from several States. Lyal, argues that State aid can not capture mismatches for which Lyal reasons there needs to be a more fundamental solution to the problem.²⁴⁷

The qualification issue in Engie, is the result of mismatch within national legislation. The Commission argues that the preferential tax treatment nevertheless affect intra community trade as Engie is an MNE. The Commission’s objective also appears to be hindering tax competition between Member States and combating tax avoidance by arguing that Luxembourg through the favorable tax treatment towards Engie “has potentially drawn investment away from Member States that cannot or will not offer a similarly favorable tax treatment.”²⁴⁸ If the Commission is pursuing the competition law objective of an internal market free from competitive distortion, the decision seems not a controversial one. Especially as the Luxembourg legislation as such is not questioned, it is the application of the rules through the tax rulings. Seen from a sovereignty point of view, the Commission’s statements are problematic as the EU does not enjoy the functional objective of tax avoidance or tax competition, at least not to the extent that it is not covered by harmonizing directives issued.²⁴⁹ Whereas the Member States still have the competence of direct tax law meaning that within limits they are free to design their own tax systems.

The tax treatments of both Apple and Belgian excess profit exemption scheme result in untaxed profits. Lyal argues that this could be viewed as an advantage stemming not from one Member State but from at least two. Lyal further questions the suitability of State aid as a tool used to control profit shifting by MNEs. Lyal reasons, the problems associated with profit shifting evolves from cross-border transactions. State aid is a tool to combat the selective advantage stemming from one Member State, not disparities between tax jurisdictions.²⁵⁰ Luja asks if exemptions are permitted if no other State will tax the exempt profits.²⁵¹ Fiscal sovereignty entails deciding what to tax and what not to tax, but the principle of equality necessitates that

²⁴⁵ C-298/05, *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt*, EU:C:2007:754, para. 39-45 and C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*, EU:C:2006:713, para. 19-24.

²⁴⁶ Wattel, P.J., *Stateless Income, State Aid and the (Which?) Arm’s Length Principle*, Intertax, 2016, p.800.

²⁴⁷ Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int’l L.J. 1017 (2015), p. 1043.

²⁴⁸ Commission Decision in SA.44888 Engie, p. 158.

²⁴⁹ Se for ex. Council Directive (EU) 2016/1164 of 12 July 2016, *laying down rules against tax avoidance practices that directly affect the functioning of the single market*, preamble, p.3 and Council Directive (EU) 2017/952 of 29 May 2017, amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

²⁵⁰ Lyal, R., *Transfer Pricing and State Aid*, 38 Fordham Int’l L.J. 1017 (2015), p. 1043.

²⁵¹ Luja, R., *Just a Notion of Aid: How (Not) to Create a Fiscal State Aid Doctrine*, Intertax, 2016, p. 789.

undertakings in comparable situations are taxed the same. Lyal questions the loss of state resources, arguing that Ireland, by its tax treatment of Apple, probably has gained rather than lost tax revenue.²⁵² From a fiscal sovereignty perspective, it could be argued that Ireland has successfully exercised the functional objective of its fiscal sovereignty which highlights the regulatory competition between Member States arising from globalization.

5.5 The analysis of the anti-avoidance rule.

In the Engie decision Luxembourg claims to have applied with the letter of the law and refers to the principle of legality as the reason to why Engie has not been taxed. In the decision, the Commission provides several lines of reasoning, one being that the selective treatment in Engie stems from issuing a tax ruling to which the Luxembourg GAAR could have been applied. The tax structure of Engie described in the Commission decision certainly gives the impression that Luxembourg has some explaining to do. Whilst not applying a GAAR when it should have been applied can result in a selective advantage, as Monsenego points out applying a GAAR is often a complex matter. The application of a GAAR tends to require a case-by-case approach and the design of a GAAR tends to allow for a certain amount of leeway so that tax authorities can analyse whether the criteria of the GAAR are fulfilled.²⁵³

5.6 Conclusion analysis.

Lyal opinions that the recent rulings²⁵⁴ follow well-established State aid praxis. For the Commission decisions in Fiat, Starbucks and Amazon, the outcome of the decisions will be dependent on the CJEU view on what should be the appropriate benchmark system, and if group companies and stand-alone companies are comparable. In addition, a decisive factor will be if the arm's length principle should be used to assess selectivity in State aid and if the transfer pricing calculations and the method chosen results in a reliable approximation of what is at arm's length. Decisions that, if the CJEU endorse the Commission position will have a fundamental impact on limiting fiscal sovereignty for the Member States. The stance the CJEU will take with regards to the arm's length principle may create further limitation to the Member States' fiscal sovereignty depending on the explicitness of the CJEU. The CJEU may for instance establish the OECD Guidelines to be applicable as a new "principle of a level playing field" or that the Member States are free to decide themselves how to establish what is at arm's length. Both of the decisions will be standard setting for the Member States and there is a risk that what is really political and ideology decisions are left for the CJEU to decide.

In the Apple and Belgian excess profit exemption rules decisions, it can be questioned if the State aid criterion of the aid being granted from one State, is fulfilled. This as the advantage stems from several States not taxing. State aid is a tool to combat the selective advantage stemming from one Member State not disparities between tax jurisdictions. The CJEU has on several occasions referred to Member States' fiscal sovereignty relieving them from needing to

²⁵² Lyal, R., *Transfer Pricing Rules and State Aid*, 38 Fordham Int'l L.J. 1017 (2015), p. 1042-1043.

²⁵³ Monsenego, J., *The Engie case: some open questions on the EU State aid rules and the prevention of tax avoidance*, Kluwer Competition Law Blog, 2018.

²⁵⁴ Lyal's paper is published in 2015 and so comments concern the Commission decisions of Apple, Fiat, Starbucks, Amazon and Belgian excess profit exemption scheme.

accommodate tax disparities arising from States exercising their sovereign taxing rights in parallel.

In *Engie*, what is crucial, is the objective the Commission is pursuing, tax avoidance or a level playing field. As well as the more practical concerns of determining whether a GAAR is applicable or not.

6 Conclusion and outlook.

This thesis is aimed at identifying the Commission's basic legal arguments in the recent decisions on State aid in direct tax law and analyzing if those decisions are intruding on the EU Member States' fiscal sovereignty based on the division of competence governing direct taxation in EU legislation. The investigation conducted has shown that State aid should be understood as a competition law tool that is meant to achieve the EU aim of an internal market free from competitive distortion. Sovereignty is a principle and as such the scope of its application is variable and dependent on the circumstances of the situation. The EU enjoy sovereign rights in the policy field of competition law and the Member State enjoy fiscal sovereignty and the right to design their own direct tax system. Both the EU and the Member States sovereignty is limited to the respective objectives of their policy fields. The Member State competence in direct taxation is further limited by its obligations to the EU. Hence, the Member States can only exercise their fiscal sovereign rights in accordance with EU law. The basic legal arguments used by the Commission in its most recent decisions on State aid in direct tax law are as follows; choice of reference system should be the corporate income tax system of the relevant Member States, the arm's length principle is part of the assessment tool of selectivity in article 107(1) TFEU, qualification mismatches resulting in non-taxation constitute a selective advantage and so does not applying a GAAR to a domestic tax arrangement.

This thesis sets out by asking if the Commission's basic legal arguments in the recent decisions on State aid in direct tax law are intruding on the EU Member States' fiscal sovereignty in direct tax law. The answer to that question is that it depends. With regards to the Commission decision in *Apple* and *Belgian excess profit exemption scheme*, it is doubtful that the criteria of the State aid article are fulfilled. If the CJEU judges in favor of the Commission, my conclusion is that such a decision will not be compatible with the EU Member States' fiscal sovereignty in direct tax law as it will create an obligation for the Member States to take into consideration the tax design of other States. This runs counter to the definition of sovereignty.

With regards to the Commission decisions in *Fiat*, *Starbucks*, *Amazon* and *Engie* my conclusion is that contrary to the EU sovereignty in the policy area of competition law, Member States' fiscal sovereignty is limited as it needs to be exercised in accordance with EU law. The EU has the functional objective, and an obligation, of ensuring an internal market free from distortive competition. As long as the aim of the Commission is prohibiting competitive distortion of the internal market and the criteria in article 107(1) TFEU is fulfilled, my conclusion is that the answer to the question, will be one of proportionality. Fulfilling the competition law objective takes precedence over fiscal sovereignty in legal order. However, when the result of the Commission decisions is that of positive integration affecting the Member States direct tax law system the CJEU will need to consider if the Commission decisions are proportionate the EU

aim or if the Commission goes beyond what is necessary to achieve the aim. The basic arguments of the reference system, being the corporate income tax system, as well as the arm's length principle as a tool to assess selectivity in article 107(1) TFEU are problematic from a fiscal sovereignty point of view. If the CJEU endorses the Commission view on the reference system, the scope of the Member States' fiscal sovereignty will be reduced, and the political choices of the shaping of a tax system moves further from the Member States towards the EU. If the CJEU endorses the Commission view on the arm's length principle in article 107(1) TFEU this will involve standard settings of the arm's length principle. These are political and ideological policy standard making decisions. In the field of direct taxation this is a competence that belongs to the Member States.

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