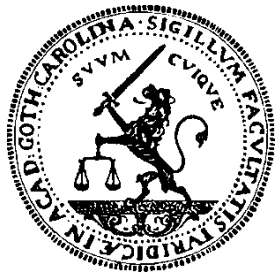

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The Commission's Approach in State Aid Assessment of Advance Pricing Agreements: an Autonomous EU Arm's Length Principle and Its Implications

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Table of contents

Abbreviation list

ALP	Arm's Length Principle
APA	Advance Pricing Agreement
Commission	European Commission
CJEU	Court of Justice of the European Union
EU	European Union
EU ALP	European Union Arm's Length Principle used by the Commission for State aid assessment purposes
MNE	Multinational Enterprise
OECD	Organization for Economic Cooperation and Development
OECD MTC	OECD Model Tax Convention on Income and on Capital
TFEU	Treaty on the Functioning of the European Union
TP	Transfer pricing

1. Introduction

1.1 Background and problem statement

In the past years transfer pricing has become a burning issue in both tax law and EU law debate and a focus of public attention. Transfer pricing provisions form part of domestic tax law and are intended to determine prices between associated parties. Within this framework, the arm's length principle (ALP) is a standard that lies at the core of most TP-provisions. It was developed by the OECD for its Model Tax Convention and has been implemented and used since long within national legislations across the world. This standard is used for tax purposes as a method of allocation of profits between associated companies that operate in different states and has been recognized internationally and in the EU. Thus, under the ALP the prices in transactions between related parties should for tax purposes be determined as if the transactions took place between independent companies. As to multinational enterprises (MNEs) that are able to take advantage of different tax regimes to minimize their overall tax liability, the ALP is also meant to prevent them from pricing their transactions so as to reallocate profit to jurisdictions with lower or no tax. Nowadays a great number of cross-border transactions are performed between related entities and the ALP is aimed at ensuring that MNEs are taxed according to value creation. Needless to say, suitable pricing plays a crucial role in the functioning of free market economies as it determines an efficient distribution of resources.

While MNEs structure and plan their business so as to optimize their tax, governments seek to attract foreign investments and taxpayers. Member States have sovereignty in direct tax matters and there is a lack of harmonization in direct taxation across the EU, which leads to tax competition between states and mismatches that MNEs can take advantage of. Nonetheless, this fiscal autonomy can be limited, as domestic tax provisions and their application must comply with the EU law to ensure the proper functioning of the internal market.

Concerned by the aggressive tax planning and tax avoidance by MNEs, the Commission initiated in 2013 – 2014 a series of investigations into tax rulings and advance pricing

agreements (APA) provided by several Member States to MNEs that endorsed their transfer mispricing practices. The Commission established[1] that the misapplication of the ALP by Member States resulted in provision of illegal State aid prohibited by Article 107 of the Treaty on the Functioning of the European Union (TFEU).

The Commission's reasoning was seen as controversial as it applied the ALP as a principle (not a domestic rule) for state aid purposes. According to this approach, the ALP is an expression of the principle of equal treatment and is inherent in Article 107 TFEU. This 'EU ALP' declaration initiated an intense debate among scholars on whether State aid law can actually be interpreted in this way and what are consequences of such interpretation for EU law and Member States' direct tax legislation and fiscal autonomy.

The debate was reinforced by the recent decisions of the General Court in *Starbucks* and *Fiat* cases[2] where it accepted the application of EU ALP to identify State aid. At the moment the discussion remains, while the world is awaiting the CJEU's stance on the issue.

At the same time, domestic ALP-provisions have also been assessed by the CJEU in the light of fundamental freedoms. Therefore, together with State aid provisions, they need to be in line with the requirements imposed by the case law. In this regard, there are also concerns that the Commission's recent practice and its arguments might be in conflict with the way the CJEU treats the ALP from the free movement law perspective.

Meanwhile, Luxembourg Leaks scandal[3] in 2014 and the Commission's recent investigations triggered a public outrage with concerns about tax avoidance by MNEs

[1] See Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C) (ex 2014/NN) implemented by Netherlands to Starbucks [2017] OJ L 83/38; Commission Decision (EU) of 21 October 2015 on State aid SA.38375 (2014/C) (ex 2014/NN) which Luxembourg granted to Fiat [2017] OJ L 351/1; Commission Decision (EU) 2017/1283 of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) implemented by Ireland to Apple [2017] OJ C 369/1; Commission Decision (EU) 2018/859 of 4 October 2017 on State aid SA.38944 (2014/C) (ex 2014/NN) implemented by Luxembourg to Amazon [2018] OJ L 153.

[2] Judgment of 24 September 2019, Netherlands v Commission, T-760/15 and T-636/15, EU:T:2019:669 (T-755/15 and T-759/15 Starbucks), Judgment of 24 September 2019, Luxembourg v Commission, T-755/15 and T-759/15 EU:T:2019:670 (T-755/15 and T-759/15 Fiat).

[3] Luxembourg Leaks scandal in 2014 revealed to the public tax rulings granted to numerous enterprises that reduced their tax liabilities. See also Keena, Colm 'Luxembourg leaks controversy a 'game changer'' Irish Times 2014 < https://www.irishtimes.com/business/economy/luxembourg-leaks-controversy-a-game-changer-1.1992650> last accessed 25 February 2020.

facilitated by Member States. Under this rising pressure, the Commission has shown determination to continue its strong action to fight tax avoidance and harmful tax competition through enforcing State aid law against incompatible national TP rules and measures.

As a result, there is an ongoing academic discussion on whether the Commission's approach in assessing TP cases goes in line with the current EU law framework and what its potential implications are.

1.2 Aim and contribution

This thesis aims to reveal whether the Commission's approach in the State aid assessment of APAs is in line with the current EU law framework and whether, given its implications, it is a sensible development in State aid law applied to taxation. In order to do that, the Commission's recent decisions along with its arguments accepted by the General Court will be analyzed against the provisions and case law applicable to TP rules. In addition, the analysis will cover the implications of the Commission's practice on the further interpretation of State aid law that may impact the Member States' fiscal sovereignty and national TP rules and policies.

Therefore, in this analysis, a series of sub-questions will be considered:

- What is the scope and application of State aid law as laid down by the TFEU and the existing CJEU case law?
- How does the Commission interpret the State aid rules in its recent proceedings?
- What requirements are imposed by the CJEU in its free movement case law for application of national ALP-based provisions?
- What is novel and problematic about the Commission's approach in the context of both State aid control and national TP legislation?

The conclusions reached in this research are expected to reveal the controversial aspects of the Commission's approach and its negative impact and to suggest possible modifications

to it. These conclusions are expected to contribute to the ongoing debate on the appropriateness of the Commission's practice of the State aid assessment of APAs.

1.3 Method and materials

In this research the legal dogmatic method will be used to help to clarify the content of the provisions and rules based on the analysis of different legal sources. In particular, the analysis will focus on the TFEU provisions, the CJEU case law, the Commission's decisions in the recent State aid cases as well as relevant decisions of the General Court. With regard to TP and the ALP, the OECD Guidelines will be used as they generally constitute a basis for domestic TP rules. Since the developments in the Commission's practice are recent and it is yet uncertain whether the approach will be upheld by the CJEU, the state of law in this regard is unclear and, thus, the academic literature is used in the research to further the analysis.

1.4 Outline

Chapter 2 will introduce the background of the ALP, looking into its origin, purpose and application in tax law. Next, the fundamentals of State aid regime and its relevance to taxation will be discussed in Chapter 3. Following the basics of State aid rules, Chapter 4 will examine and summarize the Commission's recent practice of State aid assessment of APAs endorsing transfer prices granted to MNEs by Member States. As some of the Commission's decisions have already been reviewed by the General Court, the relevant rulings will be analyzed in Chapter 5. The application of the ALP has also been assessed by the CJEU under internal market law, so Chapter 6 will consider how the CJEU treats the ALP and what rules and requirements it has established. Chapter 7 will analyze the Commission's approach against other frameworks considered in the previous chapters to conclude why the Commission's interpretation of State aid rules in the recent cases is problematic and what legal and practical issues it might raise for Member States and MNEs.

2. The background of ALP

In order to introduce the reader to the problem of this thesis, it is crucial to consider the background of the ALP, namely, its origin, purpose, material content and application.

2.1. The history and legal background of the ALP

The history of the ALP dates back to the early 20th century. The principle originated in the US and later spread internationally through the model conventions of the League of Nations and of the OECD. The US TP-legislation and its proactive policy in the field of transfer pricing influenced the development of the principle on an international scale, as the world witnessed the rise of cross-border trade of global corporations.

Within the OECD framework, the definitive statement of the ALP is laid down in Article 9 of the OECD Model Tax Convention (OECD MC)[4]:

> *' [Where] conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'*

This internationally agreed wording of the ALP first appeared in the OECD's 1963 Draft Double Taxation Convention[5] and remained unchanged in each subsequent edition of the OECD MC.

However, countries that included the ALP in their double tax treaties interpreted and applied the principle in accordance with their domestic law, so the content and scope of the ALP was then defined solely by national law. Moreover, most countries did not have detailed rules on how to establish the arm's length price. This changed when in 1979 the

[4] Model Tax Convention on Income and on Capital (OECD 2017) (OECD MC), Article 9(1).
[5] London and Mexico Model Tax Conventions Commentary and Text. — C.88.M.88.1946.II.A. (Geneva, November 1946) — Volume 4 Section 1: League of Nations.

OECD introduced their first Transfer Pricing Guidelines (TP Guidelines)[6], a report that contained internationally agreed principles and guidelines as to the application of the ALP laid down in the OECD MC. As the TP Guidelines were published, the reference thereto was included in the commentary to Article 9 OECD MC. This connection between the TP Guidelines and double tax treaties equipped the ALP with an international content, where the TP Guidelines are the main source.[7] Since then, the TP Guidelines have been widely relied on by the OECD member states as a complementary interpretative tool for the application of their national TP rules and double tax treaties based on the OECD MC, for instance, to solve issues not addressed by the national legislation.[8] The TP Guidelines were revised several times by the OECD, *inter alia*, within its BEPS project aimed at tackling tax avoidance by eliminating gaps and mismatches that MNEs use to shift profits to lower tax jurisdictions where little or no real economic activity is performed.[9] One of the aims of the Action plan on BEPS is ensuring that 'transfer pricing outcomes are in line with value creation'.[10]

As standalone sources, the OECD MC and TP Guidelines are formally non-binding for the OECD members and there is no obligation to transpose the ALP rule into national law either.

Nevertheless, most researchers agree that, the 'legal relevance' of these sources is greater than that of soft law. Since they represent an international consensus on the interpretation of the ALP and explain the content of hard law, the TP Guidelines can be seen as 'elaborative soft law'[11] or 'soft obligation' of the OECD member countries.[12] Thus, most countries used the OECD MC as a template for their double tax treaties and observed the TP Guidelines when integrating the ALP in their domestic legislation or updating their

[6] OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 1979). The latest version of the TP Guidelines is dated 2017.
[7] Calderón José, 'The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law?' (2007) 35(1) Intertax, p 9.
[8] Ibid, p 10.
[9] OECD Policy Brief 'Taxing Multinational Enterprises. Base Erosion and Profit Shifting (BEPS)' <https://www.oecd.org/ctp/policy-brief-beps-2015.pdf> last accessed 2 April 2020.
[10] BEPS 2015 Final Reports (report on Action 8, 9 and 10) <http://www.oecd.org/tax/aggressive/beps-2015-final-reports.htm> last accessed 3 April 2020.
[11] Engelen F, *Interpretation of tax treaties under International Law* (IBFD 2004), p 451.
[12] Calderón (n 6), p 10-11.

effective TP rules. The level of alignment with the TP Guidelines varies by country but they were integrated in one way or another into national legislations across the world. Despite the differences in implementation, the principles and processes contained in the Guidelines are followed by most countries.

Within the framework of the OECD TP Guidelines, the Joint Transfer Pricing Forum (JTPF) was initiated in 2002 in the EU to advise the Commission on TP matters and propose pragmatic non-legislative solutions to practical issues raised by TP practices.[13] The JTPF operates based on consensus and has elaborated several documents to help create a common TP framework for coordinating and making national TP rules work efficiently together.[14] It also ensures the effective implementation of the EU Transfer Pricing Arbitration Convention[15] that establishes a specific dispute resolution mechanism for TP cases; the Convention copies the OECD MC provisions on the ALP and adheres to the OECD understanding of the principle.[16]

2.2. Purpose of the ALP

Within the international taxation framework, the ALP was meant to ensure correct allocation of taxing rights between states, prevent tax avoidance as well as double taxation.[17] By requiring transfer prices to be at arm's length, the rule prevents entities from reducing their tax bases and shifting profits to other jurisdictions with no or lower tax. The ALP-provision as laid down in Article 9 OECD MC double tax treaties is aimed at

[13] 'Joint Transfer Pricing Forum', European Commission website <https://ec.europa.eu/taxation_customs/business/company-tax/transfer-pricing-eu-context/joint-transfer-pricing-forum_en> last accessed 17 May 2020.
[14] Ibid.
[15] Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises 90/436/EEC [1990] OJ C 160, OJ L 225.
[16] Wattel P, 'Stateless Income, State Aid and the (Which?) Arm's Length Principle' (2016) 44(11) Intertax, p 795.
[17] Wittendorff J, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010), p 6; Miladinovic A, Petruzzi R, 'European Union - The Recent Decisions of the European Commission on Fiscal State Aid: An Analysis from a Transfer Pricing Perspective' (2019) 26(4) International Transfer Pricing Journal, Journal Articles & Papers IBFD; Buriak S, Lazarov I, 'Between State Aid and the Fundamental Freedoms: The Arm's Length Principle and EU Law' (2019) 56(4) Common Market Law Review, p 925.

preventing double taxation of MNEs resulting from adjustments to tax payable based on national TP rules.

2.3. Material content and application of the ALP

The ALP formulated and interpreted by the OECD will be taken as a basis for further analysis, since the material content of the ALP derives from the OECD soft law, rather than domestic legislation that is based on it.

The ALP requires that transactions of MNEs reflect equivalent transactions between independent entities. If transfer prices are not at arm's length, the tax base of an entity may be adjusted accordingly.

The TP Guidelines determine the ALP as a standard for establishing prices in intercompany transactions used for tax purposes[18]. This principle uses a legal fiction to allocate business income of associated entities and seeks to adjust their profits in order to determine tax base. The adjustment is made based on the prices that independent enterprises would agree on in similar transactions, also known as 'uncontrolled transactions'[19].

Within this legal fiction, by taking uncontrolled transactions as a basis for the adjustment, the ALP treats each company within the MNE as a separate entity rather than a part of one business.[20] Thus, the ALP mainly focuses on the nature and conditions of transactions compared and on whether the conditions differ from those in uncontrolled transaction. This assessment is known as 'comparability analysis' and it lies at the core of the application of the ALP. It involves two major steps: analysis of the controlled transaction and comparing it with comparable uncontrolled transactions.[21] In order to find comparable transactions, several comparability factors need to be assessed: contractual terms; functions of each party to the transaction, including assets and risks; characteristics of property/services sold; economic circumstances; and business strategies.[22]

[18] OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2017) (TP Guidelines), glossary.
[19] Ibid.
[20] TP Guidelines, para 1.6.
[21] TP Guidelines, para 1.33.
[22] TP Guidelines, para 1.36.

As can be seen, the ALP-assessment of transfer prices is a complex process that requires thorough analysis and enough available relevant data on companies and transactions. Therefore, there can be no precise results but rather an estimation or approximation of market value.[23] The goal is to collect and analyze available information to come up with a range of values that would be a reasonable estimate of an arm's length outcome.[24] If potentially comparable transactions have any material differences, special adjustments can be made to eliminate the material effects of any such differences.

2.4. TP methods

TP Guidelines offer five methods to assess whether the transactions are priced in line with the ALP. The application of these methods implies comparing either pricing or profit margins, where prices are not readily available for a certain type of transaction. The Guidelines prescribe that the most appropriate method should be chosen based to the following circumstances: the strengths and weaknesses of each TP-method, the nature of the transaction reviewed, the availability of reliable information on comparability, the degree of comparability and the reliability of comparability adjustments.[25]

2.5. Advance Pricing Agreements

Tax rulings or Advance Pricing Arrangements (APAs) are used to provide more certainty for the taxpayer and tax authorities as to the application of TP rules and the ALP. They are provided by tax administrations that approve transfer prices determined by MNEs based on the application of TP rules, or predict the application of other tax rules to specific enterprises and transactions.[26]

Although tax rulings *per se* are legal, they can be misused by tax administrations or taxpayer. In this case, a specific tax ruling might grant a tax benefit to a certain company,

[23] TP Guidelines, para 3.38; See also Monsenego J, *Selectivity in State Aid Law and the Methods for the Allocation of the Corporate Tax Base* (Kluwer Law International 2018), p 4; Lovdahl Gormsen L, 'EU State Aid Law and Transfer Pricing: A Critical Introduction to a New Saga' (2016) 7(6) Journal of European Competition Law & Practice 369.
[24] TP Guidelines, para 1.13
[25] TP Guidelines, para 1.13
[26] TP Guidelines, Section F1.

which is problematic in the light of EU State aid rules. Thus, APAs have recently become subject to the Commission State aid investigations, as will be discussed further.

3. State aid rules and taxation

This chapter will introduce the reader to State aid and touch on the fundamentals of State aid rules that are relevant for further analysis. It will also consider the relation between State aid regime and taxation.

3.1. Introduction to State aid rules

State aid rules are part of EU competition law that are aimed at preventing distortions to free competition within the internal market resulting from measures granted by Member States favoring certain undertakings or goods. State aid can be found where the financial situation of a company is improved due to intervention from state authorities that seek to protect and boost a certain sector of national economy, which causes distortion of competition within the internal market. As it is essential for the effective functioning of the internal market that companies compete on a level playing field[27], State aid measures are prohibited as a general rule.

State aid rules can be found in Articles 107 – 109 TFEU. State aid measures are prohibited, unless they fall under permitted types of aid mentioned in Article 107(2) and 107(3) TFEU that can be justified by reasons of social or economic development.[28] There are instances that require targeted aid measures to be granted to certain undertakings, such as, for example, the recent pandemic that caused significant losses for certain sectors and companies. State aid rules are meant as a regulatory tool that distinguishes justified aid from harmful aid that should be prohibited.[29]

Under State aid rules, Member States are required to notify the Commission of aid measures and receive its approval before the measures can come into force.[30] The Commission has a guiding role in carrying out State aid control, it is in charge to initiate an investigation where a measure has been adopted without the Commission's approval,

[27] Wattel P, *European Tax law* (Wolters Kluwer 2018), p 3.
[28] See Article 107(2) and 107(3) TFEU for aid compatible with the internal market.
[29] Micheau C, State aid, subsidy and tax incentives under EU and WTO law (Kluwer Law International 2014), p 37.
[30] Article 108 (3) TFEU.

which is potentially unlawful aid. If a Member State disregards State aid rules and fails to notify the Commission about an aid measure, the aid is deemed to be unlawful. As a consequence of unlawful State aid, the Commission shall issue a recovery decision that orders the Member State to recover State aid received with interest from the undertaking that benefited from it.[31] However, the Commission should not require recovery of the aid received if this would be contrary to a general principle of the EU law.[32] The period for recovery of aid is also limited to 10 years.[33]

Applied in the domain of taxation, State aid prohibition ensures that Member States do not grant through a tax ruling or other tax measure a more favorable tax treatment to a taxpayer compared to other taxpayers in a comparable situation.

3.2. Conditions of Article 107 TFEU

The notion of State aid and conditions for establishing it are laid down in Article 107(1):

> *'... 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.'*[34]

Therefore, for a measure to constitute State aid, it must fulfill all the conditions provided for in Article 107(1). The measure is considered to be State aid and may be prohibited if: (i) the measure confers an economic advantage; (ii) it is granted by a Member State through state resources; (iii) is selective – i.e. it favors certain undertakings, goods or services, where such advantage is not available to all comparable undertakings; (iv) there is (potential) distortion of competition and trade between Member States.[35]

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[31] Article 16(1) 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 [2015] OJ L 248 (Regulation 2015/1589).
[32] Ibid.
[33] Article 17 Regulation 2015/1589 (n 31).
[34] Article 107(1) TFEU.
[35] Lovdahl Gormsen L, *European State Aid and Tax Rulings* (Edward Elgar Publishing, 2019), p 11.

3.2.1. Advantage

A measure grants an advantage if it provides an economic benefit that improves the financial situation of an undertaking.[36] An advantage is established by a counterfactual analysis of the hypothetical financial situation of an undertaking in the absence of the measure in question.[37] In case the undertaking's situation would be worse without the State intervention, the measure is considered to have granted an advantage. The CJEU has also developed a Market Economy Operator (MEO) test which requires a Member State acting as a supplier/buyer to charge/pay market prices; the test reveals an advantage where the Member State did not act like a private operator would under normal market conditions.[38]

The focus is on the effect of the measure rather than its objective, cause or form. Thus, the measure can be a positive advantage or a relief from economic burdens, the latter meaning any reduction of costs that the undertaking normally pays.[39]

3.2.2. Aid through state resources

The CJEU established that this condition requires that the aid must be granted through state resources and the measure granting the aid must be imputable to the state. The imputability criterion requires that the measure is granted directly by a public authority or public sector entity.[40] To test this criterion, it is necessary to analyze whether the resources in question are available to and under the control of public authorities, they do not have to be public property.[41] The aid also needs to be granted through state resources, which along with direct transfer and commitments to transfer resources, also includes waiving payments that the state was entitled to.[42]

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[36] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016), (Notice on the Notion of State Aid), paras 66, 67.
[37] Judgment of 2 July 1974, *Italy v Commission*, C-173/73, EU:C:1974:71.
[38] Notice on the Notion of State Aid (n 36), para 74.
[39] Notice on the Notion of State Aid, para 68; Judgment of 24 July 2003, *Altmark Trans and Regierungspräsidium Magdeburg*, C-280/00, EU:C:2003:415.
[40] Judgment of 14 October 1987, *Germany v. Commission*, C-248/84, EU:C:1987:437, para 17; Notice on the Notion of State Aid, para 57.
[41] Judgment of 16 May 2000, *France v. Ladbroke Racing and Commission*, C-83/98 P, EU:C:2000:248, para 50.
[42] Notice on the Notion of State Aid, para 51.

When it comes to taxation, this part of State aid assessment is quite straightforward, since the exemption from tax has the costs-mitigation effect and results in loss of revenue for a state that would be available to the state in the absence of the aid.[43]

3.2.3. Selectivity

The advantage needs to be selective, meaning it must benefit certain undertakings, economic sectors or production of certain goods or provision of services.

Selectivity is the most difficult test within the State aid assessment and there are numerous cases where the General Court did not accept the Commission's approach to it[44] or where the CJEU overturned decisions of the General Court[45]. Selectivity can be material, meaning it favors certain economic sector, or regional, i.e. which relates to a specific region in a state.[46] A selective advantage may also be an individual aid measure that only applies to one specific undertaking or a general scheme, applicable to several economic operators. A general scheme can be selective de jure or de facto.[47] *De juro* selectivity excludes certain undertakings by explicitly stating so in the legislation. While *de facto* selectivity has an effect of excluding certain undertakings by imposing barriers making the measure unavailable to other undertakings[48]. In its fiscal aid rulings, the CJEU developed a three-step test for establishing selectivity, also known as the derogation method. [49]

Firstly, a reference system should be determined that will be used as a benchmark against which the measure will be assessed. Establishing the reference system is a crucial step that will determine the outcome of the selectivity test.[50] In fiscal State aid cases it is normally the general domestic tax law system, however the General Court has also accepted a

[43] Lovdahl Gormsen (n 35), p 13.
[44] Joined Cases C-106/09 P and C-107/09 Commission and Spain v Government of Gibraltar and United Kingdom (2011) EU:C:2011:215; Case C-487/06 P British Aggrerates and United Kingdom (2008) EU:C:2008:757; Case C-279/08 P Commission v Netherlands (2011) EU:C:2011:551 cited by Werner & Verouden, p. 120
[45] Joined Cases T-211/04 and T-215/04 cited by Werner & Verouden, p. 121
[46] Notice on the Notion of State Aid, sections 5.2 and 5.3
[47] Ibid, paras 121, 122
[48] Ibid
[49] Case C-143/99 Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH v Finanz landesdirektion für Kärnten (2001) EU:C:2001: 598
[50] Werner & Verouden (2016), p. 117

narrower reference framework that consisted of *lex specialis*.[51] The CJEU has also allowed the use of a hypothetical reference system where national system is inherently discriminatory in *Gibraltar* ruling.[52] This allowed for wide interpretation of what constitutes equal treatment in the recent Commission's cases discussed further in this paper. Secondly, it is necessary to analyze whether the measure discriminates 'between economic operators who are in a factual and legal situation that is comparable in the light of the objective pursued by the measure in question'.[53] The final step is determining whether such derogation from the reference system that favors an undertaking can be justified by the nature or general scheme of the system.[54]

3.2.4. Distortion of competition and effect on inter-state trade

Although these are two separate conditions, they usually go hand in hand and are assessed together.[55] A measure that meets the other conditions of Article 107 TFEU, is usually presumed to (potentially) distort competition and affect trade.[56]

As established by the General Court, the Commission 'merely needs to establish that the aid in question is of such a kind as to affect trade between Member States and threatens to distort competition. It does not have to define the market in question or analyze its structure and the ensuing competitive relationships.'[57]

3.3. State aid and direct taxation

As State aid rules exist within competition law, they fall within the exclusive competence of the EU.[58] If the Commission finds that national rules or measures distort competition in the internal market, it can advise Member States to amend their legislations. In case a

[51] Judgment of 7 November 2014, Autogrill v Commission, T-219/10, EU:T:2014:939, para 50; Judgment of 7 November 2014, Banco Santander and other v Commission, T-399/11, EU:T:2014:938, para 54.
[52] Judgment of 15 November 2011, *Commission and Spain v Government of Gibraltar and United Kingdom*, C-106/09 P and C-107/09, EU:C:2011:215.
[53] Werner Ph, Verouden V, EU *State aid control: Law and Economics* (Eds. Kluwer Law International 2016), para 41.
[54] Notice on the Notion of State Aid, section 5.2.3.3.
[55] Notice on the Notion of State Aid, para 185.
[56] Werner. and Verouden (n 53), p 170.
[57] Judgment of 15 June 2000, Alzetta and Others v Commission, T-298/97 and T-312/97, EU:T:2000:151.
[58] Article 3(b) TFEU, Articles 116-117 TFEU.

Member State fails to eliminate the distortion, the EU is entitled to issue the necessary directives to ensure compliance in accordance with Articles 116 and 117 TFEU.[59] These provisions, however, have never been enforced in the area of tax law, given the high level of fiscal autonomy that Member States enjoy.

The CJEU has stated on several occasions that Member States have a certain autonomy in the current state of harmonization of tax law in the EU[60] and that the direct taxation falls under competence of Member States that, nevertheless, have to exercise it consistently with EU law.[61] Moreover, due to fiscal sovereignty and division of competence, all Member States must agree unanimously to legislate jointly in the field of direct taxation.[62]

Given this, State aid rules have been used as a means to tackle harmful tax rules and measures, fostering negative integration in the domain of direct taxation. While it should be kept in mind that division of competence, the principle of conferral and State aid rules all constitute primary law and have equal value.[63]

Over the last few years, the Commission has been increasingly enforcing State aid rules against national tax measures, which raised concerns that it might be applying State aid rules inappropriately by stretching their scope over Member States' fiscal autonomy.[64]

[59] Articles 116 and 117 TFEU.
[60] Judgment of 6 December 2007, *Columbus Container Services*, C-298/05, EU:C:2007:754, para 51.
[61] Judgment of 14 February 1995, *Finanzamt Köln-Altstadt v. Roland Schumacker*, C-279/93, EU:C:1995:31; Judgment of 15 July 2004, *Spain v Commission*, C-501/00, EU:C:2004:438.
[62] Article 115 TFEU.
[63] Wattel (n 27), p. 11.
[64] Richelle I, Schön W, Traversa E, State Aid Law and Business Taxation (Eds., Springer 2016), p. 44.

4. The Commission's State aid assessment and ALP

In recent years, the Commission has been using State aid rules as a tool to tackle harmful tax competition and tax avoidance. Some of the Commission's recent decisions established State aid that resulted from misapplication of the ALP endorsed by Member States through tax rulings. This chapter will provide an overview of the Commission's decisions in question.

4.1. Fiat

Fiat decision issued in October 2015[65] became one of the first decisions within a series of the Commission's investigations into APAs. This decision established that Luxembourg granted state aid to Fiat Finance and Trade (FFT) through an APA that unduly lowered its tax. The decision was upheld by the General Court in September 2019[66], which is discussed further in Chapter 5.

4.1.1. Background

FFT is part of the Fiat group and resident in Luxembourg, providing treasury services and financing to other entities of the group in Europe. In September 2012 Luxembourg issued an APA in favor of FFT where it allowed the use of the transactional net margin method (TNMM) for determining FFT's remuneration and thus its tax base calculation,[67] which was made within the scope of the relevant domestic tax provisions. In June 2014 the Commission initiated State aid investigation into the APA.

4.1.2. Commission's decision

As a result of the investigation, the Commission found that the APA had granted a selective advantage to FFT. The Commission used the three-step analysis to establish selectivity of the APA. Thus, it started with determining the general Luxembourg corporate income tax system as a reference system, however, making no distinction between integrated or stand-

[65] Commission Decision (EU) of 21 October 2015 on State aid SA.38375 (2014/C) (ex 2014/NN) which Luxembourg granted to Fiat [2017] OJ L 351/1 (*Fiat decision*).
[66] Judgment of 24 September 2019, Luxembourg v Commission, T-755/15 and T-759/15 EU:T:2019:670.
[67] *Fiat decision*, paras 52, 55.

alone companies.[68] Luxembourg and FFT had argued that the reference system should have only included companies subject to TP rules but this argument was rejected by the Commission.[69] Then it identified a derogation from the reference system, stating that 'the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective', citing earlier CJEU case-law. [70]

The cornerstone of the Commission's analysis was identifying whether the methodology endorsed by Luxembourg deviated from a methodology 'that leads to a reliable approximation of a market-based outcome and thus from the arm's length principle'.[71] According to the Commission, 'the arm's length principle' that it applies is a part of State aid assessment and 'a general principle of equal treatment in taxation falling within the application of Article 107(1) TFEU, which binds the Member States and from whose scope the national tax rules are not excluded' and not the ALP mentioned in Article 9 of the non-binding OECD MC[72]. It supported this argument with a reference to *Belgian coordination centres* ruling of the CJEU that accepted the use of 'the arm's length principle' in a State aid case.[73]

Although the Commission did not challenge the choice of the TP-method, it considered that the way it was applied departed from a market-based outcome in line with 'the arm's length principle' as it resulted in lower tax base for FFT.[74] By endorsing it through the APA, Luxembourg granted a selective advantage to FFT within the meaning of Article 107(1) TFEU in breach of State aid rules.[75] Lastly, there was no justification found by the Commission for such preferential treatment.

To avoid further confusion, the term 'ALP' will be used in relation to the principle enshrined in the OECD instruments and national TP-provisions containing the principle.

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[68] *Fiat decision*, para 215
[69] Ibid, para 215.
[70] Ibid, para 217; Judgment of 4 June 2015, Commission v MOL, C-15/14 P, EU:C:2015:362, para 60; see also, Judgment of 26 February 2015, Orange v Commission, T-385/12, EU:T:2015:117.
[71] *Fiat decision*, para 227.
[72] Ibid, para 228.
[73] Judgment of 22 June 2006, Belgium and Forum 187 ASBL v Commission, C-182/03 and C-217/03, EU:C:2006:416 (*Belgian Coordination Centres*).
[74] *Fiat decision*, para 339.
[75] Ibid, para 371.

'The arm's length principle' that the Commission applies will hereinafter be referred to as the 'EU ALP'.

4.2. Starbucks

Starbucks decision[76] came in a joint final decision with *Fiat*. It concerned an APA issued by the Netherlands endorsing two intra-group transactions which lowered Starbucks' tax. This decision, however, was annulled by the General Court in 2019.

4.2.1. Background

Starbucks Manufacturing EMEA BV (SMBV) is a Starbucks group subsidiary resident in the Netherlands that performs coffee roasting activities and production of related goods meant for sale in Starbucks coffeeshops across the world. SMBV purchases coffee beans from Starbucks Coffee Trading SARL, based in Switzerland, and then performs coffee roasting using Starbucks know-how which is licensed by Alki Limited Partnership (Alki), based in the UK.

In 2008 SMBV concluded an APA with the Dutch authorities that endorsed payments for the purchase of coffee beans as well as royalties paid by SMBV to Alki for the know-how. In June 2014, the Commission started investigation into the APA and found the payments by SMBV were unduly high.[77]

4.2.2. Commission's decision

As in *Fiat decision*, the Commission focused its assessment on selectivity and used a similar logic as in that decision. Firstly, it took the general Dutch corporate tax system as a reference framework[78], although the parties argued that it should be limited to domestic provisions on the application of the ALP.[79] They also argued that the Commission did not

[76] Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C) (ex 2014/NN) implemented by Netherlands to Starbucks [2017] OJ L 83/38 (*Starbucks decision*).
[77] 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 October 2015 <https://ec.europa.eu/commission/presscorner/detail/en/IP_15_5880> last accessed 4 April 2020.
[78] *Starbucks decision*, para 251.
[79] Ibid, para 185.

take into consideration that integrated and stand-alone companies are not always in a similar factual and legal situation[80]. However, the Commission dismissed the argument, stating that it is irrelevant, as the objective of the Dutch corporate tax system is to tax all companies falling within its scope.[81] Derogation and selectivity were presumed to go along with the established advantage.

The main question in this case also boiled down to determining whether the payments and taxable profits were in line with the EU ALP. Again, in this analysis the Commission tested the APA not against the relevant Dutch rules but against the EU ALP stemming from Article 107(1)[82].

4.3. Apple

The *Apple decision*[83] was issued in August 2016 after a two-year investigation of the Commission into a state aid implemented by Ireland to Apple. This decision is remarkable as the Commission found that Article 107(1) TFEU requires the use of EU ALP regardless of the implementation of the ALP into domestic law.

4.3.1. Background

Apple Inc., resident in the US, is the parent company within Apple group. Apple Sales International (ASI) and Apple Operations Europe (AOE), are part of the Apple group, however they are not tax residents in the US or Ireland, they do not have a physical presence in any country but operate through branches in Ireland.[84] For the services it provides, these branches receive a service fee which forms the profit taxable in Ireland.

The two companies hold the rights to use Apple's IP rights to manufacture and sell Apple products in Europe under a cost-sharing agreement with Apple Inc. Based on this

[80] *Starbucks decision*, para 183.
[81] Ibid, paras 236, 251.
[82] Ibid, paras 264, 265.
[83] Commission Decision (EU) 2017/1283 of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) implemented by Ireland to Apple [2017] OJ C 369/1 (*Apple decision*).
[84] *Apple decision*, para 51.

agreement, ASI and AOE make yearly payments to Apple Inc. to fund research and development carried out on behalf of the Irish companies in the US.[85]

Tax rulings issued by Ireland to ASI and AOE in 1991 and renewed in 2007, accepted chosen methods for their profit allocation and allowed them to determine their taxable profit in Ireland. Only a part of the companies' profits was allocated in Ireland (the branches' profits), while most of their profits were allocated from Ireland to a 'head office' that was not based in any country but existed on paper and was left untaxed.[86] The transfer prices were only supported by a TP-report after the opening decision of the Commission.[87] It should be noted that Irish legislation did not contain an ALP rule.

4.3.2. Commission's Decision

Apple decision held that the tax rulings granted state aid to Apple in breach of Article 107 TFEU. Although the Commission reconfirmed that finding an advantage was enough to conclude it was selective, it still analyzed selectivity of the measures.

Again, the existence of a selective advantage was established since the methods of profit allocation endorsed by tax rulings departed from the EU ALP and reduced ASI's and AOE's tax base and tax liability, which did not reflect market-based outcome and derogated from the reference system – the ordinary rules of corporate taxation system in Ireland.[88] Although the Commission agreed with the parties that there is a distinction between resident and non-resident companies[89], it found that this distinction could not justify the existence of a separate reference system from the ordinary rules on corporate taxation[90].

[85] European Commission, Press release, 'State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion' 20 August 2016 <https://ec.europa.eu/commission/presscorner/detail/en/IP_16_2923> last accessed 4 April 2020
[86] Ibid.
[87] *Apple decision*, para 262.
[88] Ibid, para 412.
[89] Ibid, para 236.
[90] Ibid, para 237.

The Commission used the OECD Guidelines in its analysis, though it insists that it does not apply them directly but rather considers it as 'useful guidance'.[91] Here the parties argued that since the Irish legislation contained no ALP, general principles developed by the OECD were not applicable.[92] Apple also claimed it was inappropriate for the Commission to use State aid enforcement to harmonize national direct taxation rules by requiring Member States to observe standards such as the ALP when they are not implemented in domestic law.[93] The Commission rejected these arguments using the same EU ALP ground as in previous cases, reiterating that the principle derives from Article 107(1) TFEU and is therefore binding for Member States regardless of the (non)incorporation of the ALP in their domestic laws.[94]

4.4. Amazon

Amazon decision[95] is one of the most recent Commission's decisions issued in 2017. The Commission concluded that a tax ruling granted to Amazon by Luxembourg unduly reduced its tax payable in the country.

4.4.1. Background

Amazon EU (the operating company) operates Amazon's sales in Europe and records all profits from those sales in Luxembourg. Amazon Europe Holding Technologies (the holding company) is a limited partnership with no employees or physical presence. It holds IP rights in Europe under a cost-sharing agreement with the parent company in the US and operates as an intermediary between Amazon EU and Amazon in the US. Its sole activity was granting exclusive license to the IP rights to the operating company. Under

[91] *Apple decision*, paras 254-257.
[92] Ibid, para 152.
[93] Ibid, para 173.
[94] Ibid, para 257.
[95] Commission Decision (EU) 2018/859 of 4 October 2017 on State aid SA.38944 (2014/C) (ex 2014/NN) implemented by Luxembourg to Amazon [2018] OJ L 153 (*Amazon decision*).

Luxembourg's tax law, the operating company is subject to corporate tax, whilst the holding company is not, since it is a partnership.[96]

Luxembourg issued tax rulings in favor of the two companies, endorsing the method of calculation of royalties paid by the operating company to the holding company, as well as the tax treatment of the holding company.

4.4.2. Commission's decision

The Commission revealed that the royalty payments were unjustifiably high and they were allocated to the non-taxed holding company with the only purpose of reducing the operating company's tax base. While Amazon EU was the sole operating company in Europe managing all operations, the holding company was considered 'an empty shell' that was used for profit allocation without any economic activity behind.[97]

As in the previous decisions, the Commission held that by reducing Amazon's tax compared to market-based outcome in line with the EU ALP, the ruling granted a selective advantage in breach of Article 107(1) TFEU.[98]

Luxembourg also argued that the Commission interfered with its sovereignty in the field of direct taxation by imposing its own interpretation of the ALP.[99] The Commission rejected the argument based on the EU-law compliance obligation of Member States.

[96] European Commission, Press release, 'State aid: Commission finds Luxembourg gave illegal tax benefits to Amazon worth up to €250 million' 4 October 2017 <https://ec.europa.eu/commission/presscorner/detail/en/IP_17_3701> last accessed 4 April 2020.
[97] Ibid.
[98] *Amazon decision*, para 398.
[99] Ibid, para 290.

4.5 ALP as an inherent part of Article 107 TFEU

This section will summarize the Commission's reasoning and arguments in the decisions discussed above. It will look into more details of the two major arguments that can be derived from all the decisions: the reference system used for establishing a selective advantage and the legal basis for the EU law derived ALP (the EU ALP).

4.5.1 The reference system

In all the decisions at issue the Commission claims to have used the domestic general corporate income tax system as the reference framework rather than *lex specialis,* as had argued the Member States.[100] As can be seen in the *Fiat, Starbucks and Amazon decisions,* Member States insisted that cross-border groups should not be compared to standalone entities since the TP rules target group entities exclusively.[101] While as seen in the *Apple decision*, Ireland's argument was that resident and non-resident companies are in different situations as the former are taxed based on the worldwide income and the latter – just on income at source.[102]

Nevertheless, the Commission held that the correct reference system is the general corporate tax system of the Member States, explaining that the difference between integrated and non-integrated companies does not affect the intrinsic objective of the system to tax profits of all resident companies.[103] As long as under this system profits of both group and standalone companies are taxed in the same manner, the Commission considers them to be in a similar and factual and legal situation in light of the objective of the system.[104] Although in the *Apple decision* the Commission acknowledged a distinction between residents and non-residents, it held that such a distinction could not justify the identification of a separate reference system.[105]

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[100] *Fiat decision*, para 194; *Starbucks decision*, para 232; *Apple decision*, para 228; *Amazon decision*, para 587.
[101] *Fiat decision*, para 210; *Starbucks decision*, para 248; *Amazon decision*, para 295.
[102] *Apple decision*, para 237.
[103] *Fiat decision*, para 198-199; *Starbucks decision*, para 236; *Amazon decision*, para 593-596.
[104] Ibid.
[105] *Apple decision* (n 103).

This conclusion on the reference system allowed the Commission to establish that the profit calculation methods endorsed by the contested tax rulings led to a lower tax liability compared to non-integrated entities whose liability is calculated under market terms.

4.5.2 Legal basis for the EU ALP

The Commission has introduced the autonomous EU ALP and applied it to establish a selective advantage, stating that the newly established principle stems from Article 107 TFEU and is endorsed by the CJEU in its *Belgian coordination centres* ruling.[106] According to the Commission, this EU ALP is independent from the ALP developed by the OECD and laid down in Article 9 of the non-binding OECD MC. While at the same time it acknowledged that the OECD TP Guidelines can be used as a guidance for the application of the EU ALP for State aid purposes.[107]

This EU ALP 'is a general principle of equal treatment in taxation falling within the application of Article 107(1) TFEU, which binds the member States and from whose scope the national tax rules are not excluded.'[108] The EU law derived ALP was first declared in the *Fiat* and *Starbucks decisions*, making its way into subsequent cases, as well as the Commission's Notice on the notion of State aid[109]. Moreover, the Commission stated that since the principle is embodied in the EU law it should be binding for all Member States, notwithstanding the non-incorporation of the fiscal (OECD) ALP in the national legislations of certain Member States, which was reaffirmed in the *Apple decision*.[110] A deviation from the EU ALP would, therefore, constitute a derogation from the reference system that may lead to a selective advantage in breach of Article 107 TFEU.

[106]Judgment of 22 June 2006, Belgium and Forum 187 ASBL v Commission, C-182/03 and C-217/03, EU:C:2006:416 (*Belgian Coordination Centres*).
[107] *Fiat decision*, para 87.
[108] *Fiat decision*, para 228.
[109] Notice on the Notion of State aid, para 172.
[110] *Apple decision*, para 257.

As a legal basis for the EU ALP the Commission referenced the *Belgian coordination centres* case, where, as the Commission interprets:

> *'[..] the Court of Justice endorsed the arm's length principle as the benchmark for establishing whether an integrated group company receives a selective advantage for the purposes of Article 107 (1) of the Treaty as a result of a tax measure that determines its transfer pricing and thus its taxable base'*[111]

The *Belgian coordination centres* case concerned a tax measure that favored coordination centres established by corporate groups to provide mostly financial services to its members. Under the TP-method used (cost-plus method) to establish transfer prices between coordination centres, the centres' tax base excluded the staff and the financial costs. The CJEU held that such method of tax base calculation did not reflect the prices 'which would be charged in conditions of free competition'.[112] However, in this case the CJEU did not explicitly mention the ALP or accept that it forms part of Article 107 TFEU (the EU ALP).

Nonetheless, the Commission relied on this ruling and either stated directly in decisions that the EU ALP is endorsed by the CJEU in its *Belgian coordination centres* case or referenced the ruling in footnotes. The Commission mainly relies on two arguments from the ruling. First, that tax measures are not excluded from the scope of Article 107 TFEU.[113] And secondly, that by excluding these costs, Belgium conferred a selective advantage on the centres.[114] The reference to the *Belgian coordination centres* case was also added to the Commission's Notice on the notion of State aid where it states that the EU ALP is inherent in Article 107(1) TFEU, forms part of selectivity analysis and is binding upon Member States regardless of the implementation of the principle into national law.[115]

The Commission's interpretation of this ruling has been subject to fierce criticism and raised concerns that the legal basis that the Commission relies on is not explicit and this

[111] *Apple decision*, para 251.
[112] *Belgian Coordination Centres,* para 96.
[113] *Belgian Coordination Centres*, para. 81; *Fiat decision*, para 228; *Starbucks decision*, para 264; *Apple decision*, para 249; *Amazon decision*, para 405.
[114] *Belgian Coordination Centres*, paras 1, 95-97; *Fiat decision*, p. 223; *Starbucks decision*, p. 259; *Apple decision*, para 249.
[115] Notice on the Notion of State Aid (n 36), para 172.

declaration of an autonomous ALP embodied in the EU law might be legally problematic.[116] The Commission's approach in the decisions discussed will be analyzed in more detail in Chapter 7.

4.6 Conclusion

The decisions discussed in this chapter gave the reader an overview of the Commission's current approach to State aid assessment of TP-related tax rulings in the light of State aid rules. The Commission gave a new meaning to the arm's length principle and is now using it as a tool for State aid enforcement. This recently established approach has been subject to a heated debate among academics.

The Member States and MNEs involved in the State aid proceedings have appealed the Commission's decision and two of them have already been ruled on by the General Court, which is analyzed in the next chapter. Despite the criticism towards the Commission's controversial reasoning, the General Court endorsed the Commissions' major arguments from the decisions in *Fiat* and *Starbucks*.

[116] Wattel P, 'Stateless Income, State Aid And The (Which?) Arm's Length Principle' (2016) 44(11) Intertax, p. 801; Kyriazis D, 'From Soft Law to Soft Law through Hard Law: The Commission's Approach to the State Aid Assessment of Tax Rulings' (2016) 15(3) European State Aid Law Quarterly, p. 439.

5. Rulings of the General Court in *Fiat* and *Starbucks*

In 2019 the General Court ruled on *Starbucks*[117] and *Fiat*[118] cases. Despite the overturn of the Commission's Starbucks decision, scholars tend to agree that these rulings were a victory for the Commission as the General Court supported its several important arguments.[119]

The two cases are different in their outcome, as in *Starbucks* the Commission failed to demonstrate the conferral of an economic advantage within the meaning of Article 107 TFEU.[120] The Commission's stance was not convincing for the General Court facts-wise, so the Commission did not manage to illustrate that the tax ruling in question deviated from the EU ALP. By contrast, in *Fiat* the Commission's analysis was more thorough, which allowed it to prove that Luxembourg granted an advantage to Fiat. The important thing is that the most crucial legal arguments that the Commission relied on were accepted by the General Court in both cases.

Firstly, the General Court reconfirmed the Commissions' right to perform State aid assessment of application of the ALP, even if the measure at issue is a tax ruling or an APA.[121] This boils down to the requirement for Member states to 'exercise their competence consistently with EU law'[122].

Meanwhile, it was held in *Fiat* that 'the Commission does not, at this stage of the development of EU law, have the power autonomously to define the 'normal' taxation of

[117] Judgment of 24 September 2019, Netherlands v Commission, T-760/15 and T-636/15, EU:T:2019:669 (*Starbucks case*).
[118] Judgment of 24 September 2019, Luxembourg v Commission, T-755/15 and T-759/15 EU:T:2019:670 (*Fiat case*).
[119] Jérôme Monsenego, 'Some observations on Starbucks, Fiat, and their potential impact on future amendments to the arm's length principle' (Kluwer International Tax Blog, 28 September 2019), <http://competitionlawblog.kluwercompetitionlaw.com/2019/09/26/some-observations-on-starbucks-fiat-and-their-potential-impact-on-future-amendments-to-the-arms-length-principle/#_ftnref7> last accessed 28 March 2020; Dimitros Kyriazis, 'Why the EU Commission won't appeal the Starbucks judgment' (MNE Tax, 10 December 2019) <https://mnetax.com/why-the-eu-commission-wont-appeal-the-starbucks-judgment-37043> last accessed 28 March 2020.
[120] *Starbucks case*, para 561.
[121] See also Judgment of 14 February 2019, *Belgium v Commission*, T-131/16 and T-263/16, EU:T:2019:91.
[122] *Starbucks case*, para 142; *Fiat case*, para 104.

an integrated undertaking, disregarding national tax rules'[123]. It can, thus, be concluded from this statement that the reference system should be the national law of a Member State.

Nonetheless, the General Court did not use the national law for determining the objective of the reference system or material content to the ALP but rather made a general reference to it.[124] As to the material content of the ALP, the General Court held that:

> *'suffice it to note that it is apparent from the contested decision that that principle is a tool for checking that intra-group transactions are remunerated as though they had been negotiated between independent undertakings'.*[125]

Monsenego sees the motivation for this statement and the link to the reference system as weak, while the material content of the ALP is in fact not as clear.[126]

Without going into details, the General Court accepted the Commission's argument that independent and associated entities are comparable.[127] The General Court also recognized that only information available at the time of an APA should be taken into consideration while determining the reference system. This way, in *Starbucks* the Commission was not supposed to use later editions of the TP Guidelines for its analysis.

Interestingly enough, the General Court upheld the Commission's argument that the ALP can be used as a 'benchmark' or a 'tool' to establish the existence of advantage within the meaning of Article 107(1).[128] Moreover, it accepted the *Belgian coordination centres* ruling[129] as a basis for this argument, which also indicates the acceptance of the EU ALP. Given the confusing reasoning and unclear wordings used by the General Court, these rulings seem to have accepted the obligation to apply the ALP stemming from Article 107(1) TFEU,[130] although the General Court did not provide for its position on the legal

[123] *Fiat case*, para 112.
[124] Ibid, paras 141, 145, 147.
[125] Ibid, para 155.
[126] Monsenego blogpost (n 119).
[127] *Fiat case*, para 141; *Starbucks case*, para 149
[128] *Fiat case*, para 143.
[129] Judgment of 22 June 2006, *Belgium and Forum 187 ASBL v Commission*, C-182/03 and C-217/03, EU:C:2006:416.
[130] Monsenego blogpost.

aspects of this statement. The General Court accepted the Commission's use of the EU ALP since the ALP was incorporated in the legislations of both Member States, however, it did not go as far as the Commission in requiring that it is used regardless of the implementation of the principle.

While it was concluded that the ALP (as a TP-related principle) has an inherently 'approximate nature', the rulings did not explain how the arm's length range should be determined to be compatible with State aid rules, so that the 'inaccuracies inherent in the application of a method designed to obtain a reliable approximation of a market-based outcome' do not result in misapplication of the ALP and, thus, possible State aid allegations.[131] Therefore, the question that remains open is how the benchmark should be determined and how the norm used as a benchmark should be interpreted.[132]

Concerning the choice of a TP-method, the General Court was right in concluding that it does not *per se* entail the presence of an advantage. It found that the use of one method over another or 'the mere finding by the Commission of errors in the choice or application of the transfer pricing method does not, in principle, suffice to demonstrate the existence of an advantage'.[133] Therefore, the Commission lost in *Starbucks* as it failed to find any indication of advantage besides the use of a TP-method that the Commission did not agree with.

In both rulings, the General Court accepted certain controversial arguments used by the Commission, such as the use of the EU ALP as a criterion for establishing State aid. Unless the CJEU rules otherwise, the Commission will use the EU ALP for State aid assessment. Therefore, it is necessary to wait for the CJEU to rule on the *Fiat* case to have more certainty on the issue and, hopefully, a clearer reasoning for using the ALP as a tool for State aid assessment. While this may take a few more years, the Commission will certainly continue using the same logic in the upcoming investigations.

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[131] *Fiat case*, para 207; *Starbucks case*, para 199.
[132] Monsenego blogpost.
[133] *Starbucks case*, paras 201 – 211; Skadden, Arps, Slate, Meagher & Flom LLP, 2019 <https://www.skadden.com/insights/publications/2019/09/eu-general-court-rules-on-starbucks> last accessed 1 April 2020.

6. ALP and fundamental freedoms

As we have seen in the previous chapters, Member States are restricted by State aid rules in applying the ALP. Within the EU law framework, Member States' discretion to apply the ALP is also delimited by the TFEU provisions on the fundamental freedoms, as well as relevant case law of the CJEU. Therefore, national TP rules and measures can also be challenged by companies under the free movement provisions if they are discriminatory.

Thus, the CJEU has issued several rulings where it either used the ALP for tax purposes or tested the compatibility of national TP rules with the internal market law: *Lankhorst-Hohorst*[134], *Thin Cap GLO*[135], *SGI*[136] and *Hornbach-Baumarkt*[137]. In these rulings, the CJEU acknowledged the fiscal ALP for the purposes of preventing tax avoidance and balanced allocation of taxing rights, establishing quite strict requirements as to the proportionality of the justifications.

Member States have to make sure that they draft and enforce their TP rules consistently with both State aid and free movement provisions that are based on the same principle of equal treatment but are limiting Member States from the opposite sides – the risk of discrimination and granting a selective advantage.[138] The Commission's approach has been criticized, *inter alia*, for being inconsistent with the relevant CJEU case law. In order to discover what constitutes the EU law-compatible application of the ALP, this chapter will examine and summarize the case law. Consequently, the Analysis will further discuss whether the Commission's approach can be reconciled with the requirements for the national ALP that are derived from the CJEU case law.

[134] Judgment of 12 December 2002, Lankhorst-Hohorst, C-324/00, EU:C:2002:749 (*Lankhorst-Hohorst*).
[135] Judgment of 13 March 2007, Test Claimants in the Thin Cap Group Litigation, C-524/04, EU:C:2007:161 (*Thin Cap GLO*).
[136] Judgment of 21 January 2010, Société de Gestion Industrielle v. Belgian State, C-311/08, EU:C:2010:26 (*SGI*).
[137] Judgment of 31 May 2018, Hornbach-Baumarkt, C-382/16, EU:C:2018:366 (*Hornbach-Baumarkt*).
[138] Buriak S, Lazarov I, 'Between State Aid and the Fundamental Freedoms: The Arm's Length Principle and EU Law' (2019) 56(4) Common Market Law Review, p 907.

6.1 ALP as a restriction

The CJEU held in its case law that application of the ALP and thin capitalization rules only to cross-border situations constitutes a restriction to the freedom of establishment as it discriminates against companies with subsidiaries abroad.[139] Generally in its fundamental freedoms rulings the CJEU assesses whether domestic and cross-border situations are comparable having regard to the aims of the national law.[140] Such analysis has some similarities with that used in State aid cases, where a measure is tested against a chosen reference framework, as was discussed in Chapter 3. The necessity for the somewhat similar analysis in State aid and fundamental freedoms cases is driven by the principle of equal treatment that lies at the core of both regimes.[141]

However, there is no universal comparability analysis developed by the CJEU and the assessment is not consistent throughout the case law.[142] Furthermore, in its ALP-related case law the CJEU only acknowledged the difference in treatment but did not assess or elaborate on comparability aspect.

In the recent *Hornbach-Baumarkt* case, where Germany argued that a domestic and cross-border groups were not objectively comparable in light of the aim of the German ALP-provisions, which is protecting the tax base from being shifted abroad due to transfer mispricing[143]. This argument was supported by Advocate General Bobek who also argued for the lack of comparability and stated that the ALP-provisions were put into place *because* of the fact that foreign and domestic subsidiaries are not treated the same way.[144] The CJEU, however, did not accept these arguments and without going into comparability issue held that they rather relate to the justification based on the principle of territoriality.[145]

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[139] *Lankhorst-Hohorst*; *Thin Cap GLO*; *SGI*; *Hornbach-Baumarkt.*
[140] Judgment of 18 July 2007, *Oy AA,* C-231/05, EU:C:2007:439, para 38; Judgment of 25 February 2010, X Holding C-337/08, EU:C:2010:89 (*X Holding*), para 22.
[141] Szudoczky R, 'Convergence of the Analysis of National Tax Measures under the EU State Aid Rules and the Fundamental Freedoms' (2016) 15(3) European State Aid Law Quarterly (ESTAL), p 363–364.
[142] Szudoczky (n 141), p 365-366; Wattel P, 'Non-Discrimination à la Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases' (2015) 55(12) European Taxation, p 542–553.
[143] *Hornbach-Baumarkt*, paras 38-40
[144] Opinion of AG Bobek in Hornbach-Baumarkt, C-382/16, EU:C:2017:974, paras. 57–69.
[145] *Hornbach-Baumarkt,* para 40.

Nevertheless, it can be observed that in its fundamental freedoms cases the CJEU is analyzing a specific rule that treats domestic and cross-border situations differently, so it focuses on the aim of a specific rule, not on the aim of the tax system in general.

6.2 **Justifications**

The CJEU has established certain requirements for justifications to the restrictive ALP-measures which vary depending on the rule in question. Starting with the anti-abuse justification, the CJEU held in *Lankhorst-Hohorst* that it can be accepted only if the national rule is aimed at 'preventing wholly artificial arrangements'.[146] National law should in this case provide 'for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons'.[147] The domestic rule at issue was a thin capitalization rule that did not meet these criteria and discriminated based on place of establishment of the creditor. The CJEU maintained this approach in *Thin Cap GLO*, where it held that the ALP can be used for establishing abuse, meaning that non-arm's length terms may result in presumption of abuse.[148]

The *SGI* was the first ruling on the TP-matters and there the CJEU accepted as a justification the need for balanced allocation of taxing powers and prevention of tax avoidance'[149] The balanced allocation of taxing powers was initially tied together with the anti-abuse[150] until in 2010 it was accepted by the CJEU as a standalone justification.[151] However, in the most recent ALP-related case, *Hornbach-Baumarkt*, the CJEU nonetheless linked the balanced allocation of taxing rights with anti-abuse at the proportionality stage.[152]

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[146] *Lankhorst-Hohorst*, para 37.
[147] *SGI*, para 71.
[148] *Thin Cap GLO*, para 83.
[149] *SGI*, para 69.
[150] Judgment of 13 December 2005, Marks & Spencer, C-446/03, EU:C:2005:763; Judgment of 12 September 2006, Cadbury Schweppes, C-196/04, EU:C:2006:544; Judgment of 18 July 2007, Oy AA, C-231/05, EU:C:2007:439.
[151] *X Holding.*
[152] *Hornbach-Baumarkt*, para 49.

This difference in the justifications can be explained by the different purposes that the rules were meat for.[153] Since thin capitalization rules pursue an anti-abuse objective, using the anti-abuse justification seems appropriate. Whereas the purpose of ALP is broader and also includes the correct allocation of taxing rights.[154] Therefore the use of different justification grounds seems to be reasonable given the different nature of these types of rules.

6.3 Proportionality

The proportionality requirements were established quite strictly by the CJEU. Although the cases concerned different types of rules, the same proportionality test developed in *Thin Cap GLO* was applied by the CJEU in the subsequent rulings.

In *Thin Cap GLO* the CJEU established two proportionality requirements for an anti-abuse rule:

> *(1) the taxpayer must be given an opportunity, without any undue administrative constraints, to provide evidence of the commercial justification of the non-arm's length terms;*
> (2) *the re-characterization of interest must be limited to the part that exceeds what would have been agreed at arm's length.* [155]

Thus, the same proportionality test was used by the CJEU later in *SGI* and *Hornbach-Baumarkt* despite the fact that both concerned ALP-provisions aimed at balanced allocation of taxing rights rather that anti-avoidance, as was discussed in the section above. Although in *Hornbach-Baumarkt* anti-abuse was not even argued for as a possible justification, the CJEU just added it on top of balanced allocation of taxing powers in the proportionality assessment without providing any reasoning.[156] This way, applying these proportionality requirements in *Hornbach-Baumarkt,* the CJEU established that non-arm's length terms should be accepted if there are certain commercial justifications such as company's

[153] Buriak and Lazarov (n 138), p 937 – 938.
[154] See Section 2,2 (n 17).
[155] *Thin Cap GLO,* paras 82-83.
[156] *Hornbach-Baumarkt,* para 49.

economic interest in the financial success of its subsidiaries abroad or its responsibility as a shareholder in the financing of the subsidiaries.[157]

Buriak and Lazarov have questioned the applicability of this test to the ALP-provisions, since it is based on the anti-abuse doctrine that does not work perfectly for testing ALP-rules because they have different purpose and economic rationale.[158] They suggested that the CJEU should develop a particular proportionality test for ALP that would correspond to the purpose of the balanced allocation of taxing powers used as a single justification not linked to anti-abuse.

Nevertheless, as the case-law stands today, it was recognized that non-arm's length pricing is assumed to be abusive, while non-arm's length terms still can be accepted if justified by providing evidence of the commercial justification of such terms. By requiring Member States to accept pricing that departs from ALP where justified, this stream of case law has also limited their powers to (re)allocate profits.[159]

[157] *Hornbach-Baumarkt,* para 56.
[158] Buriak and Lazarov, p 943-944.
[159] Wattel P, 'Stateless Income, State Aid and the (Which?) Arm's Length Principle' (2016) 44(11) Intertax.

7. Analysis

The Commission's approach in the recent State aid investigations regarding APAs has sparked a lot of criticism. This chapter will critically assess the Commission's position and challenge its most problematic arguments to demonstrate what legal and practical issues it raises and what consequences it can have. Thus, it will analyze whether this approach is in line with the State aid rules and internal market law and whether the EU law derived ALP is a sensible development within the current EU law and international tax law framework.

7.1 The EU ALP and fiscal (OECD) ALP

By declaring the autonomous EU ALP, the Commission, although used the same notion, departed from the ALP in its traditional universally recognized meaning. The ALP is initially a fiscal principle developed by the OECD for the purposes of appropriate pricing of transactions for tax purposes and prevention of double taxation. The EU ALP has a different role of ensuring a level playing field for all undertakings and protecting free competition within the internal market.[160] Thus, the principle was taken from the tax law context to competition law and given a new function of a benchmark within the State aid assessment. As Wattel suggests, the Commission's reasoning in the recent decisions would have caused less controversy if it chose another name for the principle, such as 'level playing field principle' or 'equality principle'.[161]

The Commission distinguishes its ALP from the OECD ALP provided for in Article 9 OECD MTC and claims the EU ALP derives from Article 107 TFEU and is accepted by the CJEU. Neither TFEU, nor the CJEU case law mention the EU ALP explicitly or provide any explanations with regard to the meaning, scope or application of the principle. Although the Commission separates the EU ALP from the OECD ALP, it at the same time references the OECD TP Guidelines. Thus, it states that it might have regard to TP Guidelines and that arrangements in line with the TP Guidelines are unlikely to constitute State aid. The 'unlikely' part is not defined, which raises legal certainty issue, as well as

[160] Wattel P, 'Stateless Income, State Aid and the (Which?) Arm's Length Principle' (2016) 44(11) Intertax, p. 792.
[161] Ibid.

the fact that the EU ALP also contradicts the universally agreed understanding of the notion of ALP. It is unclear how national tax administrations can have legal certainty that the ALP they apply based on the OECD MTC and TP Guidelines complies with Article 107(1) TFEU.

The Commission also emphasizes the non-binding nature of the OECD MTC and TP Guidelines compared to the EU law derived EU ALP. The OECD sources constitute soft law but they have been used by most Member States as a basis for implementing and interpreting the ALP within their domestic legislations. The Commission has elevated the EU ALP to be primary EU law which prevails over Member States domestic law that might already have the OECD ALP implemented.[162] The new principle is also binding upon Member States whose national law does not provide for the ALP. By establishing that any deviation from the ALP potentially leads to State aid, the Commission imposes the EU ALP upon national direct tax law.

This development is definitely problematic in relation to Member States' fiscal autonomy. Lovdahl Gormsen argues that inventing another version of the ALP specific to the EU law interferes with the Member States' fiscal autonomy.[163] Jaeger also suggests that if a Commission's State aid decision has a norm creating effect that shapes domestic tax policy, the Commission has exceeded its authority and emphasizes that State aid is meant to be used for correcting distortive effects on free competition.[164] Along with giving a new meaning to the ALP, the Commission insists on the obligation for all Member State to apply the ALP. Most authors argue such an obligation may be in conflict with existing national TP rules and is also at odds with Member States' fiscal autonomy, including the powers to decide not to tax income.[165] State aid rules do not imply an obligation to levy

[162] Lovdahl Gormsen L, *European State Aid and Tax Rulings* (Edward Elgar Publishing 2019), p 43-44.
[163] Ibid, p 45.
[164] Richelle I, Schön W, Traversa E, *State Aid Law and Business Taxation*, (Eds. Springer 2016), p 44.
[165] Monsenego J, *Selectivity in State Aid Law and the Methods for the Allocation of the Corporate Tax Base* (Kluwer Law International 2018), p. 43, 55.

income tax and the negative implications of the lack of tax is an issue of harmful tax competition which is not a State aid matter.[166]

In the recent decision in *Fiat*[167] the General Court accepted the EU ALP, so the Commission is expected to use this logic in future unless the CJEU overturns the decision. Luja points out that this is a political matter and the outcome can be dependent on the CJEU judges and on whether they are committed to fighting harmful tax competition or protect Member States' fiscal sovereignty.[168]

As to the implications of the emergence of the EU ALP at an international level, Lovdahl Gormsen concludes that the Commission's approach with the EU ALP at its basis might be counterproductive to the OECD's efforts in taxation of MNEs, especially within the BEPS project.[169] Reaching an international consensus on the TP rules has required over twenty years of significant efforts of the OECD and its members. The Commission's unilateral declaration of the EU ALP might be harmful for the cooperative climate necessary for the multilateral project.[170] While the EU itself is not an OECD member but Member States are, they might be restrained by the EU law with regard to the BEPS project.[171] Moreover, the OECD is currently working on the amendments to TP rules that are supposed to compensate for the disadvantages of the ALP-regime in the context of digital economies.[172] Monsenego believes that the Commission's practice might be in conflict with these amendments as well, since the proposed amendments will be applied to MNEs only, excluding independent entities and domestic groups, which potentially

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[166] Luja R, 'The selectivity test: the concept of sectoral aid' in Micheau C, Rust A, State Aid and Tax Law (Wolters Kluwer 2013), 112; Szudoczky R, 'The Sources of EU Law and Their Relationships: Lessons for the Field of Taxation' (IBFD 2014), 490.
[167] Judgment of 24 September 2019, Luxembourg v Commission, T-755/15 and T-759/15 EU:T:2019:670 (*Fiat case*).
[168] Luja R, 'Just a Notion of Aid: How (Not) to Create a Fiscal State Aid Doctrine' (2016) 44(11) Intertax, p 789.
[169] Lovdahl Gormsen (n 162), p 138.
[170] Ibid.
[171] Micheau C, *State Aid, Subsidy and Tax Incentives under EU and WTO Law*, (Kluwer Law International 2014), p 37.
[172] See OECD, 'Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy' 2019 < http://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf > last accessed 10 May 2020.

constitutes State aid according to the Commission.[173] This conflict might also influence the OECD's efforts towards eliminating the imperfections of the current ALP-regime in the digital context.

7.2 Legal Basis of the EU ALP

The Commission justifies the application of the ALP for State aid purposes by stating that the ALP it applies is an expression of principle of equality and is inherently part of the selectivity assessment under Article 107(1) TFEU and thus is binding upon Member States.[174] It also supports this argument by claiming that the EU ALP was endorsed by the CJEU in the *Belgian coordination centres* case. This ruling established that accepting transfer prices that 'do not resemble those which would be charged in conditions of free competition' may result in State aid.[175] The ruling, however, did not explicitly mention the notion of the ALP. The main argument from *Belgian coordination centres* case used by the Commission as a basis for the EU ALP is the fact that tax rules are not excluded from the scope of Article 107 TFEU.[176] Thus, the Commission does not explain how the ALP became a general principle of equal treatment.

Monsenego explains that the *Belgian coordination centres* ruling cannot be interpreted as imposing an obligation to apply the ALP for two reasons. Firstly, the argument of the CJEU that the Commission relies on relates to establishing an advantage rather than selectivity.[177] In this ruling the CJEU established selectivity of the measure in question was only available to certain types of undertakings, not because of inherent deviation from the ALP.[178] The second reason is the lack of support for the argument in the wording of the ruling, as it did not in fact explicitly require the application of the ALP specifically. Luja also points out

[173] Jérôme Monsenego, 'Some observations on Starbucks, Fiat, and their potential impact on future amendments to the arm's length principle' (Kluwer International Tax Blog, 28 September 2019), <http://competitionlawblog.kluwercompetitionlaw.com/2019/09/26/some-observations-on-starbucks-fiat-and-their-potential-impact-on-future-amendments-to-the-arms-length-principle/#_ftnref7> last accessed 28 March 2020.
[174] Commission Decision (EU) of 21 October 2015 on State aid SA.38375 (2014/C) (ex 2014/NN) which Luxembourg granted to Fiat [2017] OJ L 351/1 (*Fiat decision)*, para 228.
[175]Judgment of 22 June 2006, Belgium and Forum 187 ASBL v Commission, C-182/03 and C-217/03, EU:C:2006:416 (*Belgian Coordination Centres)*, para 96.
[176] Ibid, para 28.
[177] Monsenego (n 165), p 31; See also *Belgian Coordination Centres*, paras 95 and 97.
[178] Monsenego; *Belgian Coordination Centres*, para 119.

that the expression 'free competition' was not defined by the CJEU, which means that it is not necessarily the conditions existing between independent entities that should be considered for tax base allocation purposes as the only benchmark for free competition.[179] It was clearly the Commission that later derived the ALP from the words 'free competition'.[180]

Even if this ruling could be considered as an endorsement of the ALP by the CJEU, the principle applied in the case was not the EU ALP derived from Article 107 TFEU but rather the fiscal ALP for tax base calculation purposes. It was used by the Commission to test whether the method for profit calculation applied provided for the market-based outcome, i.e. arm's length prices. In this regard it is worth noting that in the opening decisions in *Fiat, Starbucks and Apple*[181], the Commission held that the ALP applied for State aid purposes was the OECD ALP. The standalone EU ALP inherent in Article 107 TFEU was first mentioned only when the *Fiat* final decision and Notice on the notion of State aid were issued in 2015 and 2016 respectively. The General Court, however, accepted the Commission's arguments in *Fiat* without providing any more clarity than the Commission already did.

Monsenego also argues that the principle of equal treatment does not require Member States to tax MNEs based on the ALP. The author recalls that the ALP as developed by the OECD does not provide for complete equality between associated and independent enterprises, and equality is not desirable since they may be in different situations.[182] Moreover, he argues that equality can also be achieved with other (non-arm's length) allocation methods.

[179] Luja R, 'Do State Aid Rules Still Allow European Union Member States to Claim Fiscal Sovereignty?', (2016), 25(5) EC Tax Review, p 323 cited by Monsenego.
[180] Joris T, De Cock W 'Is Belgium and Forum 187 v. Commission a Suitable Legal Source for an EU "At Arm's Length Principle"?' (2017) 15(4) European State Aid Law Quarterly, p 614.
[181] As cited by Lovdahl Gormsen, p 45: Commission Decision of 11 June 2014 State aid SA.38375 (2014/NN) (ex 2014/ CP) Luxembourg Alleged aid to FFT, para 14; Commission Decision of 11 June 2014 State aid SA.38374 (2014/C) (ex 2014/NN) (ex 2014/CP) Netherlands Alleged aid to Starbucks, para 12; Commission Decision of 11 June 2014 State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP)Ireland Alleged aid to Apple, para 56.
[182] Monsenego, p 43.

This way, it can be concluded that Article 107(1) TFEU cannot be interpreted as imposing an obligation to apply the (EU) ALP, and this obligation cannot be derived from the *Belgian coordination centres* case alone either. Thus, most scholars agree that this legal basis that the Commission relies on is not explicit or conclusive enough to declare an autonomous EU ALP stemming from Article 107 TFEU.[183] Clearly, this can be seen as an expansive interpretation of the said law by the Commission.

7.3 Reference system and comparability

In the discussed decisions the Commission has established the national general corporate income tax system, making no distinction between integrated and non-integrated companies. The relevant CJEU case law allows the use of this system, however, as has previously been mentioned Chapter 3, the General Court has also accepted a narrower reference framework that was comprised of *lex specialis*.[184]

It can be argued that a narrower system should be used, since integrated and standalone entities are not comparable as they are in different factual and legal situation. Unlike non-integrated companies, group entities are able to manipulate the allocation of their profits and losses and they are therefore subject to special rules, such as TP provisions. The use of the general corporate tax rules as a reference system, thus, undermines national TP and other rules applicable only to group entities, as they can be challenged as State aid using the Commission's approach.[185]

The Commission also reasoned its choice of reference system by stating that a narrower reference framework 'may open for regulatory technique to be used by the Member States that may render the State aid provisions ineffective' with the reference to the *Gibraltar* case.[186] Based on this ruling, the Commission did not take into consideration national tax system when defining the 'normal' taxation but rather used the EU law as a benchmark. Thus, it stated that the EU ALP is part of the State aid assessment under Article 107(1)

[183] Wattel (n 160); Lovdahl Gormsen, p 45.
[184] (n 51).
[185] Lovdahl Gormsen, p 60.
[186] Judgment of 15 November 2011, Commission and Spain v Government of Gibraltar and United Kingdom, C-106/09 P and C-107/09, EU:C:2011:215.

TFEU regardless of whether the ALP is incorporated in national law[187]. This indicates that the Commission is in fact using an external reference system instead of national law. Galendi points out that the Commission's decisions dictate how national tax policy must be designed to ensure the level playing field, which demonstrates the existence of a supranational reference framework.[188] Other academics also argue that the reference system cannot be comprised of or supplemented by Article 107(1) TFEU, it cannot be autonomously derived from the EU law or be defined by reference to tax rules applied in other Member States.[189] Most scholars argue that the framework chosen by the Commission is too broad and not in line with State aid rules and the use of national law would be more appropriate.[190] Monsenego adds that the reference framework should have a definite material content, meaning that it must be defined precisely and include binding elements (sources of law) of the corporate tax system of a Member State.[191] The precise identification of the reference system is crucial, otherwise it is impossible to correctly establish a deviation from that system. The fact that the Commission's selectivity analysis does not have regard to domestic tax system and imposes the ALP with an undefined scope as a benchmark also illustrates that the Commission interprets Article 107(1) TFEU expansively and encroaches on Member States tax sovereignty.

Interestingly enough, the General Court ruled that the Commission is not empowered to define the 'normal' taxation and disregard national rules, so the reference framework should be the national law[192]. At the same time, it still accepted the use of the EU law derived ALP as a benchmark. It is therefore unclear what this will mean for situations like in Apple decision, where the national law does not provide for the ALP, since the same logic will clearly lead to the use of external reference system.

[187] *Fiat decision*, para 228.
[188] Galendi RA, 'State aid and Transfer Pricing: The Inherent Flaw Under a Supranational Reference System' (2018) 46(12) Intertax, p 995; See also Lovdahl Gormsen, p 56.
[189] Richelle, Schön, Traversa, p 9; Monsenego, (n 164), p 43; Monsenego, p 43.
[190] Dimitrios A Kyriazis, 'From Soft Law to Soft Law Through Hard Law: The Commission's Approach to the State Aid Assessment of Tax Rulings' (2016) 15 European State Aid Law Quarterly, p 434; Buriak and Lazarov, p 925; Lovdahl Gormsen, p 56.
[191] Monsenego, p 52, 205.
[192] *Fiat case*, para 112.

7.4 The EU ALP and internal market law

As was previously analyzed, the CJEU has also established certain requirements for the EU-law compatibility of domestic ALP provisions in light of the free movement provisions, some of which seem to be inconsistent with the Commission's approach. Both State aid and free movement provisions imply equal treatment as a fundamental principle of internal market[193] but restrict Member States from the opposite sides. State aid rules prevent Member States from granting a competitive advantage through endorsing mispricing, whereas the fundamental freedoms ensure that the cross-border transactions of associated entities are not treated worse than equivalent domestic transactions. Therefore, Member States should not be too restrictive and discriminate between undertakings when applying the ALP, while they must not be too permissive either so that they provide an advantage and violate State aid prohibition.[194]

Starting with the notion of the ALP, it is necessary to clarify that the CJEU accepted the ALP as a fiscal principle used for the purposes of allocating taxing powers and based on the OECD MTC. If the CJEU accepts that the EU ALP is a standalone principle, the existence in the CJEU case law of two different principles under the same name might be harmful for legal certainty in the EU.

The CJEU established that the ALP can be applied by Member States to tackle 'wholly artificial arrangements' and ensure balanced allocation of taxing right and imposed strict proportionality requirements to justify the application of the ALP.

Whereas the Commission requires unconditional application of the EU ALP and explicitly does not allow a deviation from market-based outcomes, the CJEU considers it possible if justified by commercial reasons[195]. Thus, scholars argue that the two statements cannot be reconciled as the CJEU free movement case law that established the possibility to deviate

[193] Micheau, 'Fundamental freedoms and State aid rules under EU law: The example of taxation' (2012) 52(5) European Taxation (2012), p 210; Szudoczky R, 'Convergence of the Analysis of National Tax Measures under the EU State Aid Rules and the Fundamental Freedoms' (2016) 15(3) European State Aid Law Quarterly (ESTAL), p. 379; Buriak and Lazarov.
[194] Buriak and Lazarov, p. 907.
[195] *Hornbach-Baumarkt.*

from the ALP contradicts the Commission's idea that the ALP is inherent in EU law.[196] Acceptance of non-arm's length prices by tax authorities might result in State aid allegation and commercial justifications such as 'interest in success of the subsidiary' would always be an overriding commercial justification. Therefore, the unconditional application of the EU ALP might result in breach of internal market provisions, whereas by departing from the ALP as accepted by the CJEU Member States risk to breach Article 107 TFEU. So far, it seems that the simultaneous compliance with the two approaches is quite challenging and there is clearly a need to reconcile them. It can be concluded that either the Commission should adjust its approach to the existing CJEU case law on fundamental freedoms or the CJEU needs to provide some clarity as to the relation between the two regimes.

Wattel concludes that the EU ALP has a different purpose and effect from the fiscal ALP that the CJEU has previously accepted. While the latter limits the Member States' powers to (re)allocate profits to their jurisdictions, the EU ALP that the Commission is using limits their possibilities to accept underallocation of profits in their jurisdictions for reasons of tax competition.[197] Other scholars also suggest that the CJEU could develop separate proportionality requirements for the ALP with the balanced allocation of taxing powers as a primary objective[198] and abandon the concept of commercial justifications, which would bring the free movement case law closer to the Commission's approach.[199]

Even if the CJEU later accepts the Commission's approach notwithstanding the lack of legal basis and controversy, it will have to make sure it does not contradict its internal market case law. Otherwise it will be challenging for Member States to simultaneously comply with both State aid rules and internal market law when drafting and enforcing their TP rules.[200]

[196] Buriak and Lazarov, p 945; Monsenego, p 43-44; Lovdahl Gormsen, p 49.
[197] Wattel, p 795.
[198] Buriak and Lazarov, p 946.
[199] Lovdahl Gormsen, p 50.
[200] Buriak and Lazarov, p 934; Lovdahl Gormsen, p 50.

8. Conclusion

This paper has illustrated that the Commission's approach in its recent negative State aid decisions on APAs is based on certain controversial arguments and is potentially problematic for numerous reasons. To recapitulate, the Commission declared the existence of a standalone ALP that is embodied in Article 107(1) TFEU and must be used for State aid assessment.

Firstly, it is still unclear from the Commission's reasoning what meaning and scope it gives to the ALP it is using for State aid purposes (the EU ALP). It separated the EU ALP from the principle developed by the OECD, however, there are indications that without the OECD context the EU ALP cannot be considered or used autonomously. It was discovered that if used as a standalone principle, it clearly lacks legal basis and has an undefined scope. The Commission still assimilates the EU ALP with the OECD ALP to a certain degree, facilitating its argumentation for State aid purposes while bringing uncertainty within the tax law framework. This creates challenges for both national tax law with its own TP rules and international taxation context. As the Commission gives a new meaning and function to the ALP, it undermines the traditional understanding of the principle, as well as impedes multilateral efforts within the OECD in developing and improving TP rules and policies.

It can also be concluded from the analysis of the decisions that the Commission has its own interpretation of Article 107(1) TFEU and relevant CJEU case law. Thus, the Commission has used an external reference framework for its analysis and established that Member States are bound by the EU ALP even if their national law does not provide for it. It was established through the analysis that the declaration by the Commission of the ALP inherent in Article 107(1) TFEU is in fact novel and has a weak legal basis. Moreover, this development implies that all Member States now should implement the ALP or apply their existing TP rules in accordance with the Commission's interpretation. Given this, the Commission's approach seems to be an expansive interpretation of State aid rules that encroaches on the Member States' fiscal autonomy and raises legal certainty issues.

The Commission's arguments and findings indicate that it attempts to achieve negative integration in the field of direct taxation. This is, however, not an initial purpose of the State aid rules that are essentially meant to protect free competition. This is a political issue and it is yet unclear how the CJEU will resolve it. The Commission's approach is widely criticized by academics and specialists who argue that the CJEU should limit this negative integration that the Commission is using to foster harmonization in direct tax matters.

The Commission's approach is hard to reconcile with the existing case law of the CJEU on fundamental freedoms. While the CJEU required Member States to accept pricing that departs from the ALP if commercially justified, the Commission does not allow non-application of the EU ALP, which makes the margin for Member States' error quite narrow. As a result, this conflict can lead Member States to inevitable infringement of the EU law by violation of either State aid prohibition or internal market law. Given this conflict, it becomes extremely challenging for Member States to design and apply ALP-based TP rules.

The General Court upheld the Commission's approach, so unless the CJEU rules otherwise, a deviation from the EU ALP may result in a selective advantage in breach of article 107(1) TFEU. In case the CJEU accepts the standalone EU ALP that forms part of State aid analysis within the meaning of Article 107(1) TFEU, the Commission will be empowered to impose its own TP policies in the EU. While the CJEU rulings on the issue are expected to take a few years, the Commission will certainly apply the same reasoning in its upcoming investigations and decisions. Needless to say, this approach will definitely have a significant impact on tax ruling practices and MNEs' TP strategies and tax planning.

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