January 17, 2017

State Aid and Tax

The European Commission's Application of the State Aid Rules to Tax – Where Are We Now?

SUMMARY

The European Commission established a task force in 2013 to look at the "tax planning practices" of multinationals. 2016 brought its work into the open. The Commission has published:

- decisions that tax rulings granted by Belgium, Luxembourg, the Netherlands and Ireland to a number of high-profile multinational taxpayers, constituted unlawful state aid; and
- two policy documents that aim to shed light on the Commission's approach to state aid in the context of transfer pricing and tax rulings.

Investigations into other multinationals are ongoing.

The Commission's actions raise concerns both about how it evaluates alleged fiscal state aid, and about whether the Commission is impermissibly encroaching on the sovereign right of Member States to determine their own national tax systems.

In December the Court of Justice of the European Union quashed the General Court's judgment in *World Duty Free Group* and extended the circumstances in which a measure may be considered "selective" and vulnerable to challenge as state aid.

Now is a good time for multinationals to take stock of their own positions in light of the relevant principles and the Commission's new and evolving approach.

WHAT IS STATE AID?

Article 107(1) of the Treaty on the Functioning of the European Union (**TFEU**) provides:

> "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".

Four elements must be present for a measure to constitute state aid:

i. An advantage for the beneficiary of the measure;
ii. "Selectivity", in that the advantage is not available to all comparable businesses;
iii. Funding by the Member State or through State resources; and
iv. An effect on trade between Member States and a distortion or threatened distortion of competition.

Measures satisfying these criteria can be lawful in certain circumstances, by falling within one of several exemptions, some of them available as of right, others requiring application to the Commission for clearance in advance of implementing the measure.[1] There is also a carve-out for measures that would result in aid with a value of less than €200,000 over three fiscal years.

The state aid rules are broad and, therefore, capable at least theoretically of encompassing many types of favourable tax treatment that may be granted by a Member State, whether in the form of statutory exemption or tax ruling, where that treatment is given (on its face or in effect) selectively to a particular undertaking or category of undertakings or in respect of certain goods or services.

If the Commission finds that a measure constitutes unlawful state aid, it must require the relevant Member State to recover the aid, with interest, from the beneficiary (unless such recovery would be contrary to a general principle of EU law). The Commission can order recovery of state aid up to 10 years after the aid was granted, although this period can be extended if any action is taken by the Commission or by a Member State (at the request of the Commission) with regard to the aid.[2]

BACKGROUND

It is a core principle of EU membership that Member States enjoy autonomy over their fiscal affairs. However, as the Working Paper on State Aid and Tax Rulings issued by the Directorate-General for Competition in 2016 points out, "any fiscal measure a Member State adopts must comply with the EU state aid rules, which bind the Member States and enjoy primacy over their domestic legislation."[3] This creates a natural tension, and there remains a question mark over the extent to which the Commission may be justified in countermanding aspects of national law on state aid grounds.

Until recently, the Commission's state aid investigations in the tax sphere had tended to examine "aid schemes" – rules applying to any taxpayers falling within their terms – rather than "individual aid". In particular, in a series of decisions in the mid-2000s, the Commission found the "coordination centre" regimes operated by several Member States to be unlawful state aid.[4]

1 For example, to remedy damage caused by natural disasters (Article 107(2)(b) TFEU) or to promote the economic development of deprived areas (Article 107(3)(a) TFEU).

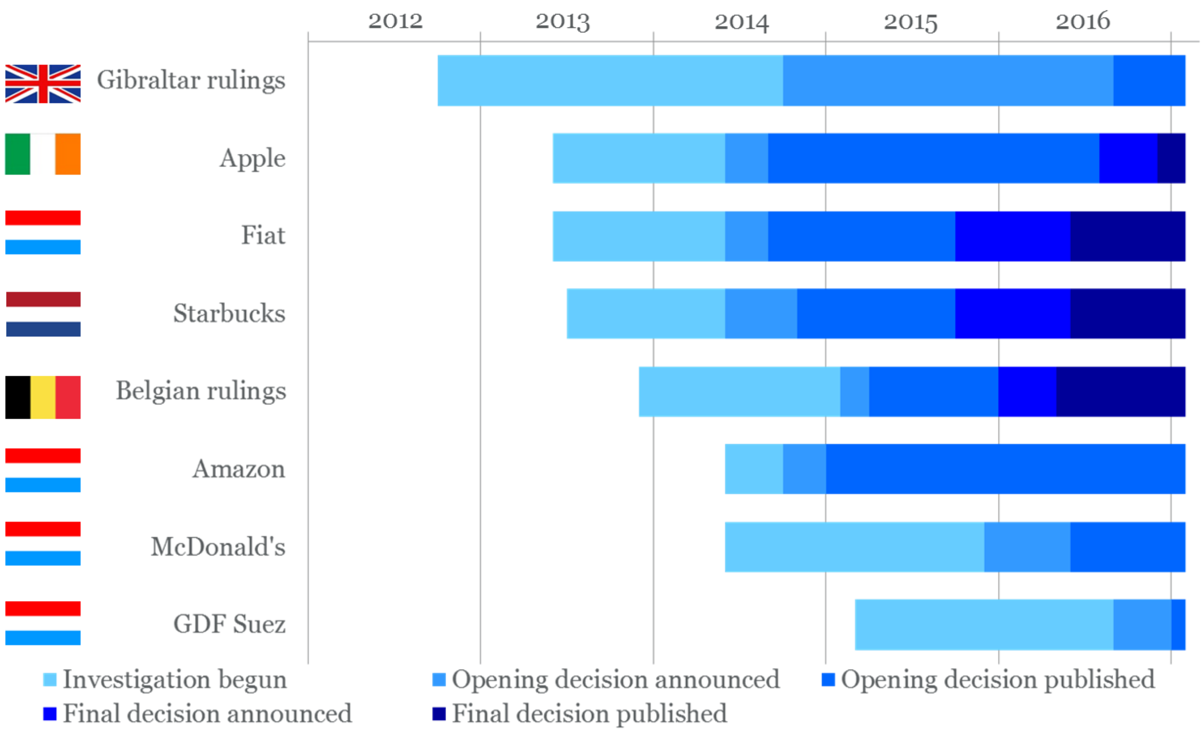
2 Council Regulation 2015/1589, Article 17.

3 Paragraph 2 of the Working Paper; this goes back to the case of *Commission* v *Italy*, Case C-173/73, decided in 1974.

4 "Coordination centres" were companies providing services (such as banking, marketing, and personnel management) to other companies in their group. The Commission found the transfer pricing analysis applied in respect of these intra-group services to be unlawful state aid.

More recently, however, the Commission has shifted its focus to individual aid in the form of rulings given by Member States to specific taxpayers. In 2013, against a backdrop of increasing media coverage of the tax affairs and structuring of multinationals, the Commission set up a dedicated task force to look at "tax planning practices". That year the task force began state aid investigations into specific rulings granted to subsidiaries of Apple, Fiat Chrysler Automobiles and Starbucks (by Ireland, Luxembourg and the Netherlands respectively). In the following two years it opened further investigations into Luxembourg's treatment of subsidiaries of Amazon, McDonald's and GDF Suez (now known as Engie). In October 2015 it announced negative decisions against the relevant Member States in *Fiat* and *Starbucks*.

Meanwhile, the Commission had also been looking at Gibraltar's tax ruling practice and the Belgian excess profit rulings regime.



DEVELOPMENTS IN 2016

Although the Commission had announced decisions in the *Fiat* and *Starbucks* cases in late 2015, it was in 2016 that the Commission publicly revealed the new thinking underlying those decisions.

As well as the Working Paper on State Aid and Tax Rulings, the Commission has issued a Notice on the Notion of State Aid.[5] Unlike the Working Paper, the Notice covers areas other than tax, but it includes extensive sections dedicated to fiscal state aid.

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5 Commission Notice on the Notion of State Aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, 2016/C 262/01, OJ 19.07.2016. The Notice, the Working Paper, the Commission's final decisions in *Belgian Excess Profit Rulings*, *Fiat*, *Starbucks* and *Apple* and the Commission's opening decisions in *Amazon*, *McDonald's* and *GDF Suez* are all

The Notice and the Working Paper set out the Commission's approach in theory; the decisions published by the Commission offer some insight into what this means in practice.

The Commission published final decisions in the *Belgian Excess Profit Rulings*, *Fiat*, *Starbucks* and *Apple* cases, finding that the relevant Member States had granted unlawful state aid in each case. The Commission has (in contrast to the coordination centre decisions) required the Member States concerned to recover the alleged aid. The amounts of alleged aid vary: in the case of Apple, the recovery obligation amounts to approximately €13 billion (plus compound interest), whereas the amounts at stake in the *Starbucks* and *Fiat* cases are significantly smaller (stated by the Commission to be approximately €20 - €30 million each).

In addition, the Commission published the opening decisions in *Amazon*, *McDonald's* and *GDF Suez* (the last of these at the beginning of January this year). Although not final, these do shed light on the Commission's thinking.

Finally, in December the Court of Justice of the European Union gave its judgment in the important joined cases of *World Duty Free Group* (formerly Autogrill), *Santander*, and *Santusa*.[6] The CJEU agreed with the Commission that, contrary to the General Court's findings, the Spanish goodwill amortisation regime for foreign acquisitions constituted unlawful state aid.

	2016
January	Final decision in *Belgian Excess Profit Rulings* ordering recovery
February	US Treasury writes to Commission expressing concern over new approach to state aid Commission responds
May	Final decision in *Belgian Excess Profit Rulings* published Final *Notice on the Notion of State Aid* published
June	*Working Paper on State Aid and Tax Rulings* published Opening decision in *McDonald's* published Final decision in *Fiat* published Final decision in *Starbucks* published
August	US Treasury issues White Paper on state aid cases Final decision in *Apple* ordering recovery of ~€13bn plus interest
September	Opening decision in *GDF Suez* Opening decision extending the investigation of the Gibraltar Corporate Tax Regime to cover rulings
December	Final decision in *Apple* published CJEU judgment in *World Duty Free Group*
	2017
January	Opening decision in *GDF Suez* published

From the Commission's perspective, its activism on fiscal state aid accords with the international focus on greater transparency in tax affairs and efforts to tackle cross-border tax arbitrage, both of which are exemplified by the OECD's BEPS Project and a number of measures at EU level. These measures extend to tax rulings: as of January 1, 2017, information on cross-border rulings and advance pricing agreements issued by Member States must be automatically exchanged with other

available on DG COMP's tax rulings web page: http://ec.europa.eu/competition/state_aid/tax_rulings/index_en.html.

6 Joined cases C-20/15 P and C-21/15 P; see our memorandum of December 2, 2014, on the decision of the General Court (in cases T-219/10 and T-399/11), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_EU_State_Aid_and_Tax_Law.pdf.

Member States.[7] The measure was announced in 2014 and is in keeping with Action 5 of the BEPS Project, which aims to tackle "harmful tax practices".

Thus far the proceedings have been conducted at the level of the Commission and its new doctrine has not yet undergone judicial scrutiny. This will come: The *Belgian Excess Profit Rulings*, *Fiat*, *Starbucks* and *Apple* decisions have all been appealed by taxpayers and the relevant Member States. Given the timescale for the appeals process in the EU courts, and the likelihood that the General Court's decisions will be appealed to the CJEU, final resolution is likely to be some years away.

RECENT CASES AND INVESTIGATIONS

INTRODUCTION

In the meantime, it is helpful to examine the recent cases and investigations and the Commission's approach to the issues so that multinationals can better assess the potential impact of the state aid rules on their own positions. We have set out the facts of each case in brief below and illustrated them with diagrams (simplified where appropriate). As the Commission has shifted its ground on some of the more controversial aspects of its analysis over the course of the year, we have taken its decisions in reverse chronological order. But we turn first to the judgment of the CJEU.

CJEU JUDGMENT

World Duty Free Group (formerly *Autogrill*) and *Santander*

A Spanish regime allowed companies acquiring a shareholding of at least 5% in a non-Spanish company to amortise the part of the value representing underlying goodwill for tax purposes, provided the shares were held for a minimum of 12 months. The regime did not allow amortisation for an equivalent shareholding in a Spanish company. In 2014 the General Court held that the Commission had failed to show that the goodwill amortisation regime was "selective" for state aid purposes, since it applied to all undertakings (albeit those carrying out specific economic transactions), and not to a particular group of companies within the Member State. The Advocate General, and then the CJEU, disagreed with the General Court. The CJEU held that it was not necessary to identify a particular category of undertakings with specific characteristics that would exclusively benefit from the alleged aid. It was sufficient on the facts that Spanish law gave an advantage to companies acquiring foreign entities over and above companies acquiring domestic entities.

COMMISSION DECISIONS

GDF Suez

Opening decision September 2016, published January 2017.[8]

The Commission is investigating rulings given to Luxembourg subsidiaries of GDF Suez which accepted that an intra-group loan might be recognised by one party as debt, and by the other party as equity for Luxembourg tax purposes. The effect of the rulings is apparent non-taxation of either lenders or borrowers within the group on profits arising in Luxembourg. The Commission's

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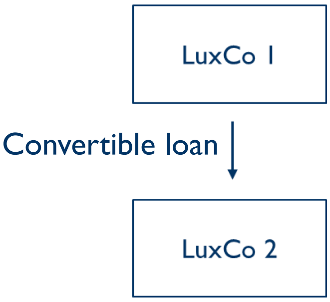
7 Directive 2011/16/EU, as amended by Council Directive 2015/2376/EU.

8 Case SA.44888.

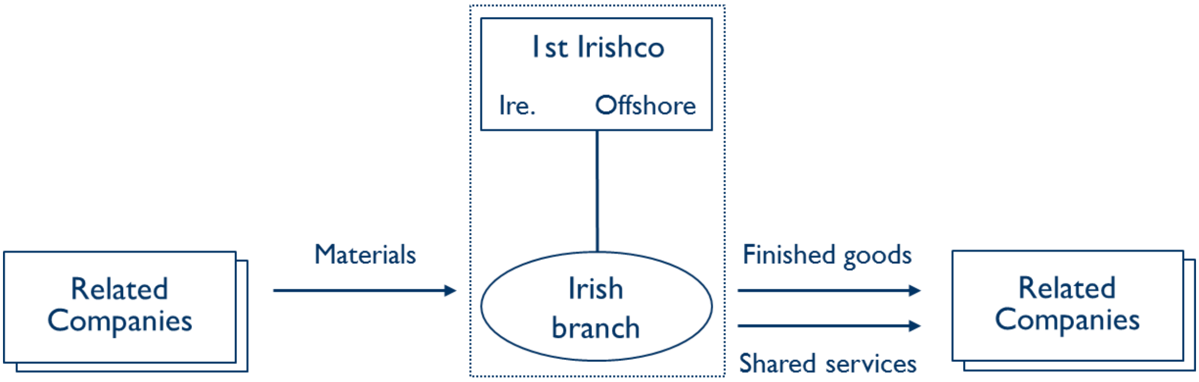
preliminary decision is that Luxembourg has misapplied its law in several respects, including transfer pricing: either no interest should have been recognised as deductible by the borrowers or, failing that, the lender should have recognised taxable income.



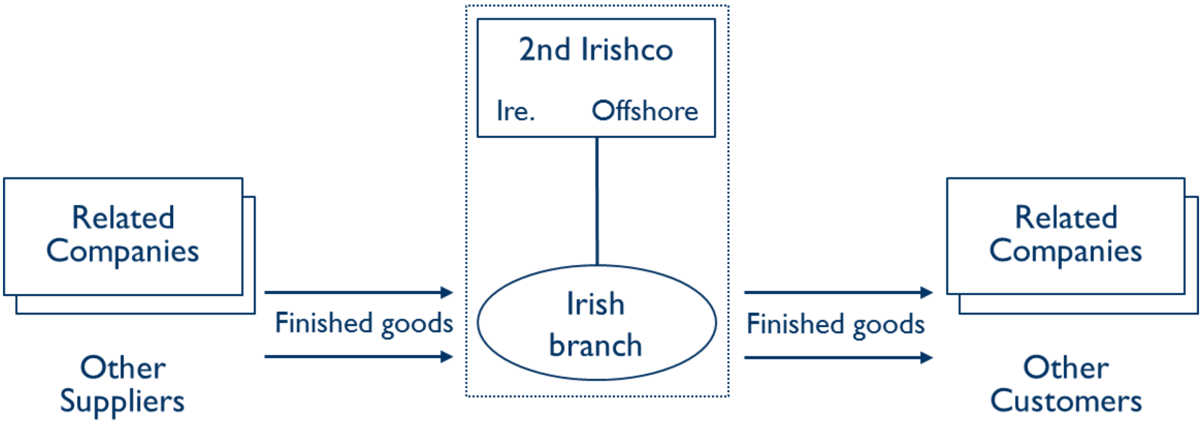
Apple

Final decision August 2016, published December 2016.[9]

The *Apple* decision relates to two Irish-incorporated subsidiaries of Apple, Inc. Under Irish law during the relevant period, the two subsidiaries were not considered resident in Ireland; nor were they resident in any other jurisdiction for tax purposes. The subsidiaries did, however, conduct operations through branches in Ireland (manufacturing and the provision of support services to related companies in one case; procurement, sales and distribution in the other). The subsidiaries obtained rulings from Ireland on how much of their profits should be attributed to those branches. The profits attributed to the branches were in each case a small proportion of the whole (and did not include revenue derived from intellectual property rights, which Apple claimed were not attributable to the Irish branches). A substantial amount of income was therefore not subject to current taxation in any jurisdiction. (The Commission found that Apple paid an effective corporate tax rate on the profits of one of its Irish subsidiaries of 1% in 2003, falling to 0.005% in 2014. If these profits were repatriated to the US as dividends, they would of course then be subject to US taxation.) The Commission found that the rulings given to the Irish subsidiaries endorsed an inappropriate attribution of profit within the Irish subsidiaries and constituted unlawful state aid.



9 Case SA.38373.



Belgian Excess Profit Rulings

Final decision January 2016, published May 2016.[10]

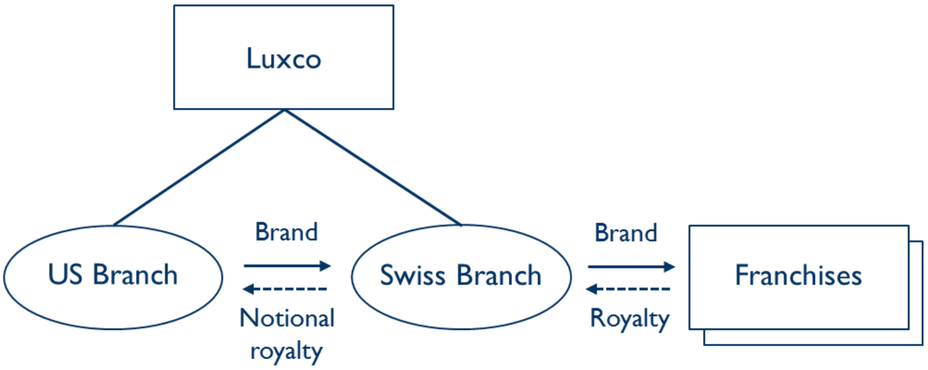
The Commission decided that an optional measure available to multinationals obtaining an advance ruling was an illegal aid scheme and ordered Belgium to recover the aid. The scheme allowed Belgian tax resident companies that were part of a multinational group to deduct from their recorded profit any "excess profit". The excess profit was the amount exceeding the hypothetical average profit that a stand-alone comparable company would have made on the same activities. The rationale was that an integrated group company should not suffer more tax on an activity just because it made a greater profit on account of economies of scale and similar advantages deriving from its membership of a group. An advance ruling from a special ruling commission was required in order to benefit from the scheme.

McDonald's

Opening decision December 2015, published June 2016.[11]

The Commission is investigating a tax ruling granted by Luxembourg to a McDonald's subsidiary in Luxembourg with branches in the US and Switzerland. The Commission found that the effect of the tax ruling was double non-taxation, as the subsidiary allocated profits to its US branch that were subject neither to US corporate income tax nor to Luxembourg corporate income tax, based on Luxembourg's interpretation of the Luxembourg/US tax treaty. The Commission's preliminary view is that Luxembourg has misapplied the treaty. This is a point of political controversy.

[10] Case SA.37667.
[11] Case SA.38945.

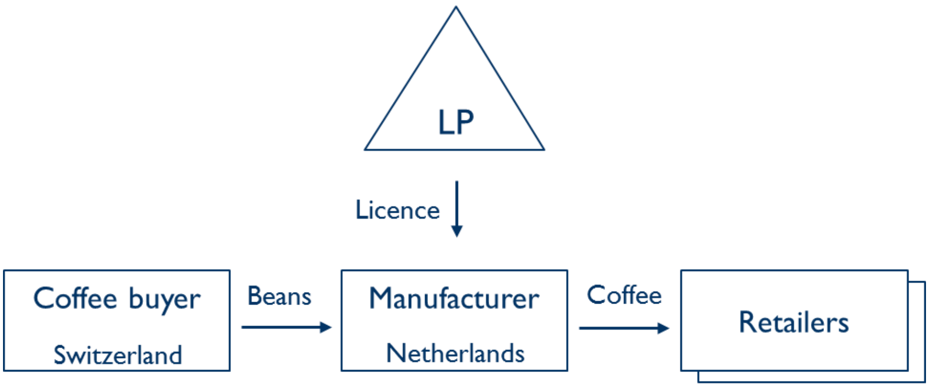


Starbucks

Final decision October 2015, published June 2016.[12]

The Commission challenged a tax ruling from the Netherlands authorities obtained by Starbucks' manufacturing subsidiary, which covered (i) the royalties paid by the manufacturing subsidiary to a limited partnership elsewhere in its group for its "coffee roasting know-how", and (ii) the price paid on an intra-group basis for the unroasted coffee beans. The Commission considered that:

- insufficient analysis had been done of the transactions;
- the wrong transfer pricing method – the transactional net margin method – had been chosen; and
- in both cases the transfer prices were too high.



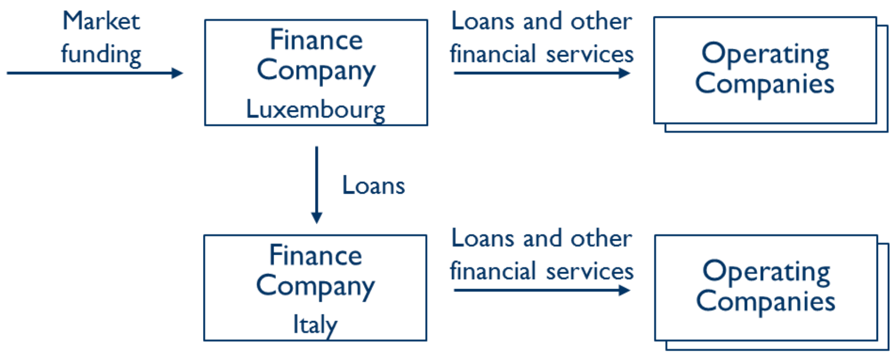
Fiat

Final decision October 2015, published June 2016.[13]

The Commission challenged an advance pricing agreement obtained by the Fiat Chrysler group's Luxembourg financing company from the Luxembourg tax authorities. The Commission dropped its initial objection that the financing company should have applied the comparable uncontrolled price method, rather than the transactional net margin method. Nonetheless, it found that the methodology applied by the company when pricing its transactions was not a reliable approximation of a market-based outcome, and questioned its methodological choices. A feature of this decision (distinguishing

[12] Case SA.38374.
[13] Case SA.38375.

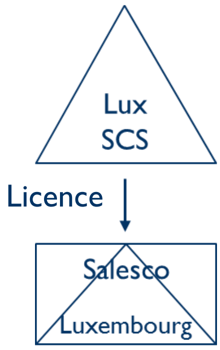
it from some of the other scenarios being considered by the Commission) is that it is not a case of double non-taxation. The question from the Fiat Chrysler group's perspective is simply whether the profits concerned should be allocated to the financing company in Luxembourg or to other financing and operating companies elsewhere in Europe.



Amazon

Opening decision October 2014, published January 2015.[14]

The Commission is assessing a ruling under which an Amazon operating company in Luxembourg (which records most of Amazon's European income) pays away substantial royalties to another group entity. The Commission questioned several aspects of the ruling, including the use of the transactional net margin method and the level of profit left in the operating company. Its preliminary conclusion was that the ruling did not satisfy the arm's length principle.



Gibraltar Corporate Tax Regime

In response to a complaint from Spain in 2012, the Commission opened a preliminary investigation into Gibraltar's new corporate income tax regime.[15] Alongside its investigation into the effect of the Income Tax Act 2010, the Commission also raised questions about Gibraltar's tax ruling procedure. The Commission has now issued opening decisions on both aspects of the investigation; the one into tax rulings was published only in October 2016, although dating from two years earlier. In this second

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14 Case SA.38944.

15 Case SA.34914, opening decisions available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_34914.

opening decision the Commission challenged 165 rulings, on the grounds that Gibraltar's procedures were inadequate and that the rulings misapplied Gibraltar law to the various sets of facts.

THE COMMISSION'S APPROACH

CASE SELECTION

The potential scope for state aid investigations is broad, as the Working Paper takes the position that "any measure by which the public authorities grant certain undertakings a favourable tax treatment which places them in a more favourable financial position than other taxpayers amounts to State aid within the meaning of Article 107(1) TFEU". In reality, however, it is the tax ruling practices of Member States that have recently attracted most attention from the Commission. This focus has been encouraged by increased media coverage and legislative scrutiny[16] of the tax planning of multinationals, and fuelled by public disclosures of confidential information such as "LuxLeaks" in 2014, in which several hundred corporate tax rulings obtained from Luxembourg by PwC and other firms were published online. As at June 2016, the Commission had examined over 1,000 tax rulings.[17]

The Commission says that it is not calling into question the practice of Member States giving rulings on tax matters, which it recognises is an important tool in providing legal certainty to taxpayers.[18] It has, however, decided that some rulings on transfer pricing have not properly applied an arm's length principle to determine transfer prices in accordance with "a reliable approximation of a market based outcome".[19] The Working Paper is clear that the Commission's target is "cases where there is a **manifest breach** of the arm's length principle" (emphasis original).

The Commission notes that it has generally found tax rulings on intra-group transactions between entities in different Member States, where each party carries out genuine economic activities on which it is taxed, to be "unproblematic"[20] – although this was not the view that the Commission took in the *Fiat* case.

The Commission is not just looking at transfer pricing rulings. The *Gibraltar* decision and the *McDonald's* and *GDF Suez* investigations all involve non-transfer-pricing rulings (although the Commission criticises the *GDF Suez* ruling and some of the *Gibraltar* rulings for not applying transfer pricing rules), and the ruling in the *Apple* decision deals with profit allocation rather than transfer pricing in the strict sense.

Moreover, it should not be assumed that the Commission will confine itself to policing advance rulings. Settlements of disputes may also attract scrutiny if the Commission believes that "the amount of tax has been reduced without clear justification" or that there have been "disproportionate concessions"

16 In particular by the US Senate Permanent Subcommittee on Investigations and the UK House of Commons Public Accounts Committee in 2012 and 2013.

17 Paragraph 6 of the Working Paper.

18 Paragraph 5 of the Working Paper; paragraph 169 of the Notice.

19 Paragraphs 13 and 14 of the Working Paper.

20 Paragraph 13 of the Working Paper.

made to the taxpayer.[21] In January 2016 a £130m settlement between Google and HM Revenue and Customs in the UK came under the spotlight. Commissioner Margrethe Vestager said that the Commission would look at the settlement under the state aid rules if it received a complaint; a complaint duly came from the Scottish Nationalist Party.

The Commission has a wide mandate to examine any measure potentially giving a selective advantage, but its resources are finite: they may not stretch to reviewing vast quantities of new information as well as running current investigations and defending appeals against the decisions it has already made. It will have to prioritise; but its priorities remain obscure. It is not clear whether the Commission intends to concentrate mainly on transfer pricing or spread its net more widely; and whether it intends to police tax rulings systematically (which it may not be well equipped to do) or make an example of a few taxpayers in the hope that this will change behaviour more generally. Certainly the tax ruling cases and investigations to date have targeted large well-known multinationals with high-profile brands, and jurisdictions whose ruling practice has been a significant part of their appeal to taxpayers. That and the Commission's reticence about its future plans suggest that it may be aiming to achieve the maximum deterrent effect for limited activity. The Commission also seems to be dealing with its resource issue by outsourcing case selection to those willing to make complaints to it: so far that has meant politicians, activists and, in the *Gibraltar* case, another Member State, but complaints could also come from competitors.[22] This is understandable on one level, but it is not the way to predictable or equitable enforcement.

ASSESSING STATE AID

Advantage, selectivity and the importance of the reference system

Investigations into fiscal state aid have tended to focus on whether a particular tax measure is "selective" for state aid purposes. If selectivity of a fiscal measure is established, it is often relatively easy to demonstrate the presence of the other criteria set out in Article 107(1) TFEU.

Selectivity is easily established where Member States adopt measures that clearly benefit certain identified undertakings, such as those in a particular geographical area.[23] Where a measure is generally applicable to all undertakings that meet certain criteria – such as the goodwill amortisation regime examined in *World Duty Free Group* – a 3-step process must be applied to determine whether an advantage is selective:

i. **Identify the appropriate "reference system"**, that is, a consistent set of rules that generally apply to all undertakings falling within the scope of that particular system;

ii. **Determine whether the measure is a derogation from the reference system**, i.e. does the measure differentiate between taxpayers "in a comparable legal and factual situation" in light of "the objectives intrinsic to the system"; and

[21] Paragraphs 175 and 176 of the Notice.

[22] The Commission has an obligation to investigate all state aid complaints from "any Member State and any person, undertaking or association of undertakings whose interests might be affected by the granting of aid, in particular the beneficiary of the aid, competing undertakings and trade associations" (Council Regulation (EU) 2015/1589, Article 1(h) and Article 12(1)).

[23] Case C-156/98, *Germany* v *Commission*, paragraph 23.

iii. **If there is a derogation, assess whether it is justified** in light of the "nature or general scheme of the system".[24]

Identifying the correct "reference system" is a crucial part of the analysis. According to the Notice, in the case of taxes, the reference system is based on elements such as the tax base, the taxable persons, the taxable event, and the tax rates.[25]

In some circumstances, a selective advantage can be intrinsic to the operation of the reference system itself, although this is exceptional. In *Commission* v *Gibraltar*[26], the CJEU found (overturning the General Court) that the proposed new Gibraltarian corporate income tax system (since abandoned) was founded on criteria of a general nature, but it in fact operated to give a selective advantage to offshore companies. This was held to be unlawful state aid.

The question of whether there is an "advantage", which "relieves the recipients of charges which are normally borne from their budget"[27], must also be examined against the backdrop of the correct reference system.

In *World Duty Free Group*, the CJEU found that the General Court had failed properly to apply the second step in the 3-step test set out above: whether the measure differentiated between taxpayers in a comparable situation. In particular, the Commission did not need to identify a particular category of undertakings favoured by the goodwill amortisation scheme in order to demonstrate selectivity.[28] The CJEU referred the case back to the General Court with a reminder that the essential part of the analysis, having established the reference system, is whether the relevant measure "irrespective of its form or the legislative means used, should have the effect of placing the recipient undertakings in a position that is more favourable than that of other undertaking in a comparable factual and legal situation in light of the objective pursued by the tax system concerned".[29]

Finally, the 3-step test allows for a derogation from a reference system to be justified in light of the "nature or general scheme" of the system. According to the Commission, a justification must be founded on what is necessary to preserve the coherence of the system, rather than "external policy objectives", which are not inherent to the system.[30] Any derogations must also be proportionate to achieve their objective.[31] The design and operation of tax systems remains a sovereign act, but state aid can fetter that right: the Gibraltarian government set up a tax system to attract offshore companies, yet its design was vetoed by the Commission and the CJEU on state aid grounds. The CJEU took an expansive view of the ability of EU institutions to decide what is the nature and scheme of a Member State's tax system.

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24 See paragraph 128 and following of the Notice, and joined cases C-78/08 to C-80/08, *Paint Graphos and others*.

25 Paragraph 134 of the Notice.

26 Joined cases C-106/09 and C-107/09.

27 Case C-88/03, *Portugal* v *Commission*, paragraph 18.

28 The CJEU found that the General Court had wrongly inferred the existence of such a "supplementary requirement" from the case law, in particular, from the Gibraltar case.

29 Joined cases C-20/15 P and C-21/15, paragraph 79.

30 Paragraphs 138-140 of the Notice.

31 Joined Cases C-78/08 to C-80/08, *Paint Graphos and others*, paragraph 75.

Now that the CJEU has overturned the judgment of the General Court in *World Duty Free Group*, it is hard to say with certainty that measures previously thought outside the scope of state aid challenge are in fact immune from challenge. For example, could the Commission assert that a participation exemption for capital gains and dividends in respect of significant percentage shareholdings constitutes unlawful state aid if that exemption is subject to material financial thresholds or is conditional upon the taxpayer carrying on certain types of activity? The fact that a measure is available to a large number of undertakings, or that those undertakings belong to various economic sectors, is not sufficient to rule out state aid.[32] On the other hand, the CJEU in *World Duty Free Group* also said that the fact that only some taxpayers could meet the conditions to benefit from a measure does not of itself mean that the measure is selective.[33]

The arm's length principle

The Commission considers that Article 107(1) allows it to apply "the arm's length principle" when assessing arrangements set out in a tax ruling against what a normal application of the ordinary tax system would be, regardless of whether the Member State has adopted that principle into national law, and in what form.[34] The Commission claims that this follows from the prohibition of "unequal treatment in taxation of undertakings in a similar factual and legal situation"[35] and is derived from case law.[36] The Commission's explanation of the principle behind this seems to be that the reference system (being the general corporate income tax system) applies to stand-alone and group companies alike; stand-alone companies by definition enter transactions on the basis of arm's length prices and are therefore also taxed on that basis; and, as a result, it would be a derogation from the general system to allow group companies to be taxed on the basis of non-arm's-length prices. The position of the Commission was highlighted in the *Apple* decision, according to which:

- Ireland had not applied the arm's length principle in allocating profits of the Apple subsidiaries to their Irish branches; and
- Ireland states that the arm's length principle was not part of the relevant Irish law; but
- the arm's length principle should nonetheless be applied.[37]

In *Apple* the Commission applies its arm's length principle to the attribution of profit to the two Irish branches: the branches must be left with the profit that they would have made had they carried out the same activities on an independent basis. But it goes further: according to the Commission, "the absence of activities related to the Apple IP at the level of the respective head offices meant that those licenses should be allocated to the Irish branches for tax purposes".[38] This amounts to saying that the Commission may focus on what the rest of the company does and allocate residual profit to the branch.

32 Joined cases C-20/15 P and C-21/15, *World Duty Free Group*, paragraph 80.
33 Joined cases C-20/15 P and C-21/15, *World Duty Free Group*, paragraph 59.
34 Paragraph 172 of the Notice.
35 Paragraph 172 of the Notice.
36 Specifically, Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL*, paragraph 95.
37 *Apple* final decision, recital 371 – see footnote 12 above.
38 *Apple* final decision, recital 280 – see footnote 12 above.

The Commission is at pains to stress in both the Notice[39] and the *Apple* decision[40] that it does not directly apply the OECD's guidelines, although it may have reference to them. Both the Notice and the Working Paper point out that "if a transfer pricing arrangement complies with the guidance provided by the OECD Transfer Pricing Guidelines … a tax ruling endorsing that arrangement is unlikely to give rise to state aid."[41]

The OECD Guidelines set out several methods available to determine transfer prices, and the Working Paper notes that multinationals are free to apply methods that are not set out in the OECD Guidelines "provided those prices satisfy the arm's length principle".[42] In practice, however, the Commission has been quick to challenge the application of the transactional net margin method as being less reliable than the comparable uncontrolled profit method.[43] Moreover, the Commission appears to have difficulty in accepting that there may be a range of possible arm's length results.[44]

What to make of this?

The basis given by the Commission for its autonomous arm's length principle is questionable. It puts more weight on a single sentence from a single case than it can reasonably bear[45]; it ignores other cases which do not mention any such principle or are inconsistent with it; and it surely cannot be right that a Member State is offering integrated companies a "derogation" from its tax system by not applying rules it has never adopted. Here the Commission is arguably encroaching on the sovereignty of Member States: it remains to be seen how the EU courts will respond.

Moreover, the Commission's approach creates real practical problems –

- It is unclear what arm's length principle the Commission is applying.[46]
- Even if its arm's length principle were clearly articulated, the Commission does not have the same depth of experience of transfer pricing as the OECD, whose Guidelines are internationally recognised, and widely adopted; for all that it may misapply the OECD Guidelines, the Commission has provided no alternative to them.
- In any event, taxpayers cannot comply with two different arm's length standards at once.

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39 Paragraph 173 of the Notice.

40 *Apple* final decision, recital 255 – see footnote 12 above.

41 Paragraph 173 of the Notice and paragraph 18 of the Working Paper. The OECD Transfer Pricing Guidelines are available at http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm.

42 Paragraph 17 of the Working Paper.

43 See the *Amazon* opening decision, *Starbucks* final decision and *Fiat* opening decision (although this point was dropped in the *Fiat* final decision).

44 See *Fiat* final decision, recital (295), in which the Commission cites paragraph 3.57 of the OECD Guidelines, which suggests using the interquartile range to narrow the set of results in appropriate circumstances, as authority for the proposition that Fiat should *not* have used the interquartile range but rather the median.

45 See footnote 34.

46 In its final decision in *Fiat*, the Commission was at pains to explain that "the arm's length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention" (recital 228); in its final decision in *Apple*, by contrast, the Commission seems to imply that the principle is the same, even if it is derived from a different source and the Commission is not bound by the OECD's guidance (see recital 255).

The Commission's apparent line on attributing profit to permanent establishments – that a Member State may be required to focus on what the rest of the company does and then allocate residual profit to the branch – is novel, contrary to principle and unsupported by the OECD's guidance.[47] This too needs correcting.

NOVELTY AND RETROACTIVITY

Is the Commission's invocation of its own arm's length principle novel? It had not been articulated in previous decisions. The Commission has nonetheless protested that its reasoning is based on firm legal ground long established in decisions of EU courts. But a more reliable guide can be found in how the Commission has approached the issue in its recent decisions: in these it has found it necessary to deploy subsidiary lines of reasoning against the possibility that its arm's length principle is rejected by the courts.

The 10-year recovery window means that there is an extensive look-back period for taxpayers to have in mind when assessing their transfer pricing arrangements. In addition, the *Apple* decision shows that counteraction can be significantly retroactive. Ireland and Apple have argued that the Commission breached the principle of legal certainty by (i) opening an investigation into a ruling 22 years after it was granted, and (ii) retrospectively applying an external framework (the arm's length principle and OECD Guidelines) that was not part of the national law at the time, and could not have been anticipated when the rulings in question were issued.[48] The Commission has responded that it had not delayed the exercise of its powers so as to breach the principle of legal certainty, since the time period for assessment only ran from the time it became aware of the alleged aid (which was 22 years after Apple's first ruling). Moreover, the Commission does not consider that it has adopted a novel approach that would breach the legitimate expectations of Apple and Ireland since no EU body had given "precise assurances" that Apple's tax rulings, or even tax rulings in general, did not constitute state aid.

There are concerns about the extent to which the Commission can or should be encroaching on Member States' fiscal sovereignty. It would be undesirable if the Commission were attempting to harmonise tax treatment across Member States using the state aid regime. In addition to acting beyond its proper authority in policing national tax systems on state aid grounds, the Commission lacks the resources or expertise to fulfil such a role.

US REACTION

The position adopted by the Commission has drawn criticism from the Treasury Department and members of the Senate Finance Committee. The Treasury Department issued a White Paper in August setting out the US government's objections to the Commission's approach to transfer pricing

47 The OECD's 2010 Report on the Attribution of Profits to Permanent Establishments.
48 *Apple* final decision, recital 439 – see footnote 12 above.

(in anticipation of the *Apple* decision, which was announced shortly thereafter).[49] The White Paper raises the following concerns:

- the "unforeseeable" departure from prior EU case law and decisional practice by the Commission;
- the retroactive application of this new legal theory, which "would undermine the G20's efforts to improve tax certainty";
- that the Commission's approach undermines the BEPS Project and the OECD Guidelines;
- that Member States may be prevented from honouring their obligations under bilateral tax treaties with the US if the Commission sets out transfer pricing analysis from which they are unable to depart in any mutual agreement procedure; and
- that US multinationals may be entitled to claim foreign tax credits in respect of state aid recoveries, which would effectively transfer revenue from the US to Member States.

(The Internal Revenue Service and Treasury Department have since issued a notice of proposed regulations which are intended to limit such claims for credit.[50])

The Commission has not responded to the White Paper, and it is unclear whether it will do so.

One commentator has suggested that the President may invoke Section 891 of the Internal Revenue Code in response to any state aid recovery. This allows the US to double certain taxes for citizens and corporations of a foreign country where the President finds that country to have subjected US citizens or corporations to "discriminatory or extraterritorial taxes". It is unclear whether the state aid recovery obligations would amount to discriminatory or extraterritorial taxes for these purposes.

IMPLICATIONS FOR MULTINATIONALS

Any ruling that derogates from domestic tax rules or, in the case of transfer pricing or the attribution of profits, from the arm's length principle, may be challenged. This is a question of substance, not process, but the Commission sees deficiencies in process as indicating potential problems with substance. If they have not done so already, multinationals should review any existing tax rulings on both counts and keep them in mind when applying for new rulings.

So far as process is concerned, red flags might be raised by:

- rulings granted with inadequate supporting evidence (in particular, without any transfer pricing report);
- rulings of overly long duration (for example, more than 3 - 5 years) and/or that do not require regular review of their applicability; and
- rulings granted in a short space of time, perhaps indicating that a tax authority does not conduct sufficient substantive analysis.

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49 Available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf.

50 See our memorandum of September 22, 2016, on the proposals, available at https://www.sullcrom.com/us-tax-consequences-of-eu-state-aid-recoupment

What is necessary in terms of substance depends, of course, on context. In the case of transfer pricing, uncertain though the position may be, taxpayers wanting to minimise the risk of a state aid challenge should ensure that their policy is consistent with the OECD Guidelines. As noted above, however, that may not be enough for the Commission. The decisions published this year have made it clear that the Directorate-General for Competition has its own view of transfer pricing practice. It prefers the comparable uncontrolled price method to the transactional net margin method; it prefers the conventional and familiar to the innovative and unfamiliar; and it appears to see transfer pricing as something closer to an exact science giving a single right answer than anyone else does.

Multinationals should also consider whether it may be appropriate to make or adjust provisions or disclosures to cover possible state aid investigations in their accounts (different auditors have been taking different approaches) or securities filings (depending on whether and where their securities are listed). Multinationals have a difficult line to walk here: over-disclosure may create a target for the Commission to investigate.

Disclosure and provisioning will come up again for any multinational unfortunate enough to be caught up in a Commission investigation. A key point to note here is that the taxpayer has very little in the way of procedural rights independent of the Member State (by contrast, for example, with conventional antitrust challenges). Whether the taxpayer is to have any chance of persuading the Commission to close an investigation without taking further action will depend very much on the stance of the Member State and its willingness to involve the taxpayer in its response to the investigation. It is likely to be extremely difficult to persuade the Commission even with the assistance of the Member State.

If the Commission issues a final decision against the multinational, there are several bases on which it may appeal, including misapplication of the relevant provisions of EU law, manifest error of assessment, or infringement of procedural requirements.

It is currently unclear whether recovery of a tax advantage arising from tax rulings that constitute unlawful state aid is itself a payment of tax. The CJEU has held that the recovery by Ireland of air travel taxes that had been effectively underpaid was for EU state aid law purposes a recovery of the original tax due (but not paid due to the availability of an unlawful exemption), rather than a new tax imposed retroactively.[51] For the purposes of transfer pricing adjustments or foreign tax credits in other jurisdictions (such as the United States), the analysis is likely to start by looking at whether the Member State required to recover the state aid treats it as a recovery of tax or something else.

How it is treated by the Member State concerned may also affect the position in M&A transactions. The concerns here are, first, whether state aid risks are covered by due diligence, warranties and any tax covenant or indemnity at all and, second, whether the limitation period on claims is long enough. It is worth noting that the CJEU decided in a 2001 case[52] that, where a company which has benefited from unlawful state aid is sold in a competitive auction, the seller has effectively kept the benefit of the

[51] Joined cases C-164/15 P and C-165/15 P, *Aer Lingus and Ryanair*, paragraph 114.
[52] Case C-390/98, *Banks* v *The Coal Authority*, paragraphs 77 and following.

aid granted up to the point of sale and it is the seller from which that aid should be recovered. This could, however, be revisited.

A footnote on Brexit: although it seems likely that the TFEU provisions on state aid will no longer apply to the United Kingdom following Brexit, the EU's policy is to include state aid provisions in negotiating proposals for agreements with third countries.[53] It should not be assumed that the UK will become a haven from state aid control.

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[53] This is set out in its Communication on an External Strategy for Effective Taxation, COM(2016) 24 final, January 28, 2016: see paragraph 3.2.

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CONTACTS

London			
	Ronald E. Creamer Jr.	+44-20-7959-8525	creamerr@sullcrom.com
	Juan Rodriguez	+44-20-7959-8499	rodriguezja@sullcrom.com
	S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com
	Andrew Thomson	+44-20-7959-8501	thomsona@sullcrom.com
	Emma Hardwick	+44-20-7959-8401	hardwicke@sullcrom.com
	Michael Engel	+44-20-7959-8476	engelm@sullcrom.com
New York			
	Ronald E. Creamer Jr.	+1-212-558-4665	creamerr@sullcrom.com
	S. Eric Wang	+1-212-558-3328	wangs@sullcrom.com
	Andrew P. Solomon	+1-212-558-3783	solomona@sullcrom.com
Paris			
	Gauthier Blanluet	+33-1-7304-6810	blanluetg@sullcrom.com
	Nicolas de Boynes	+33-1-7304-6806	deboynesn@sullcrom.com