

2023 IFA CANADA LECTURESHIP



A NORTH AMERICAN VIEW OF STATE AID

Guest Lecturer: Ruth Mason

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INTERNATIONAL FISCAL ASSOCIATION (CANADIAN BRANCH) | PRESENTED ON FEBRUARY 22, 2023

Article 107(1) TFEU

- **Prohibition on State Aid**- TFEU art. 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...shall, in so far as it affects trade between member states, be incompatible with the internal market”



Elements of Illegal State Aid

- (1) an advantage
- (2) granted by a member state
- (3) to an undertaking
- (4) that is selective and
- (5) distorts trade or competition in internal market
 - Real issue is selectivity



Determining Selectivity

- Commission determines selectivity using 3-step procedure: (1) identifies reference baseline, then (2) shows that state deviated from baseline in way that benefitted some enterprises while failing to benefit (3) other enterprises in a comparable factual and legal situation



Apple in a Nutshell



United States



Apple's tax plan shifts income from United States and rest of world to nowhere.

Irish-incorporated,
nowhere resident



Rest of world



Ireland



Moorman (the American *Gibraltar*)

- Illinois had single-factor sales
- All other states equally weighed payroll, property, and sales
- TP sued Illinois
- SCOTUS said that the Constitution does not indicate what the apportionment formula should be. It only forbids discrimination against cross-border commerce.
 - Court could have required the dominant three-factor rule or it could have supplied its own idealized rule (ALS?), but it expressly stated that it lacked authority to pick the states' tax systems for them
 - So how can SCOTUS evaluate Illinois' facially neutral regime that, as applied, leads to double tax (and tax gaps)?

U.S. SOLUTION IS THE “INTERNAL CONSISTENCY TEST”

Imagine all 50 states adopted the challenged state's rule. Would cross-border commerce face more tax than purely domestic commerce? If yes, state law is illegal. If not, it's generally permissible.

Alter for state aid: If all MSs had the rule, would cross-border commerce (or this sector, etc., pick your suspect class) face *less* tax than domestic commerce (other sectors)? If yes, aid must be justified. If no, it's generally permissible (as a mismatch).

Mismatches “pass” internal consistency test

- McDonald’s
 - If everyone had Luxembourg’s concept of PE, business profits, and treaty interpretation approach, then the United States would have taxed the U.S. activities of the Lux Co. No double nontaxation
- Apple tax residence mismatch
 - If everyone had Ireland’s tax residence rule, the Apple subs would have been tax residents of the United States. No double nontaxation
- Gibraltar
 - If everyone had Gibraltar’s payroll and property tax, all offshore companies would be taxed on 100% of their income across all the taxing states. No double nontaxation
- In actual practice, internal consistency test does not mandate “single tax” because regimes can differ from each other (e.g., U.S. tax residence rule is just as internally consistent as the Irish)

Advantages

- You don't need to know what's the main rule and what's the deviation
- Avoids tax-expenditure trap (what's included in the baseline?)
- Internal consistency test reliably identifies mismatches (different tax rates, Irish tax residence by management vs U.S. tax residence by incorporation), so Commission will not invade MS sovereignty by invalidating mere mismatches
 - Any tax advantage that disappears under the harmony assumption derives from a mismatch

Advantages of Reference-Law Benchmarking

- These advantages apply to both the ordinary tax-expenditure approach and internal consistency test
- Commission never has to supply an external reference base
 - TFEU assigns the tax legislative power to the Council and Parliament, not the Commission
 - Commission has no democratic mandate or accountability; no special tax expertise
 - Not terribly offensive when Commission can rely on OECD standards, but Gibraltar!

Disadvantages

- Permits tax competition
- Allows the Gibraltar payroll-and-property tax and the old Irish tax-residence rule. States will surely take advantage
- Maybe that's good, or at least tolerable

Conclusions

- EU courts should continue to reject the Commission's *sui-generis* arm's-length standard in favor of the Member States' own domestic-law income allocation rules, as tested by internal consistency
- Gibraltar was wrongly decided
- One-sided TP methods may confer state aid, but still may be justified

THANK YOU!

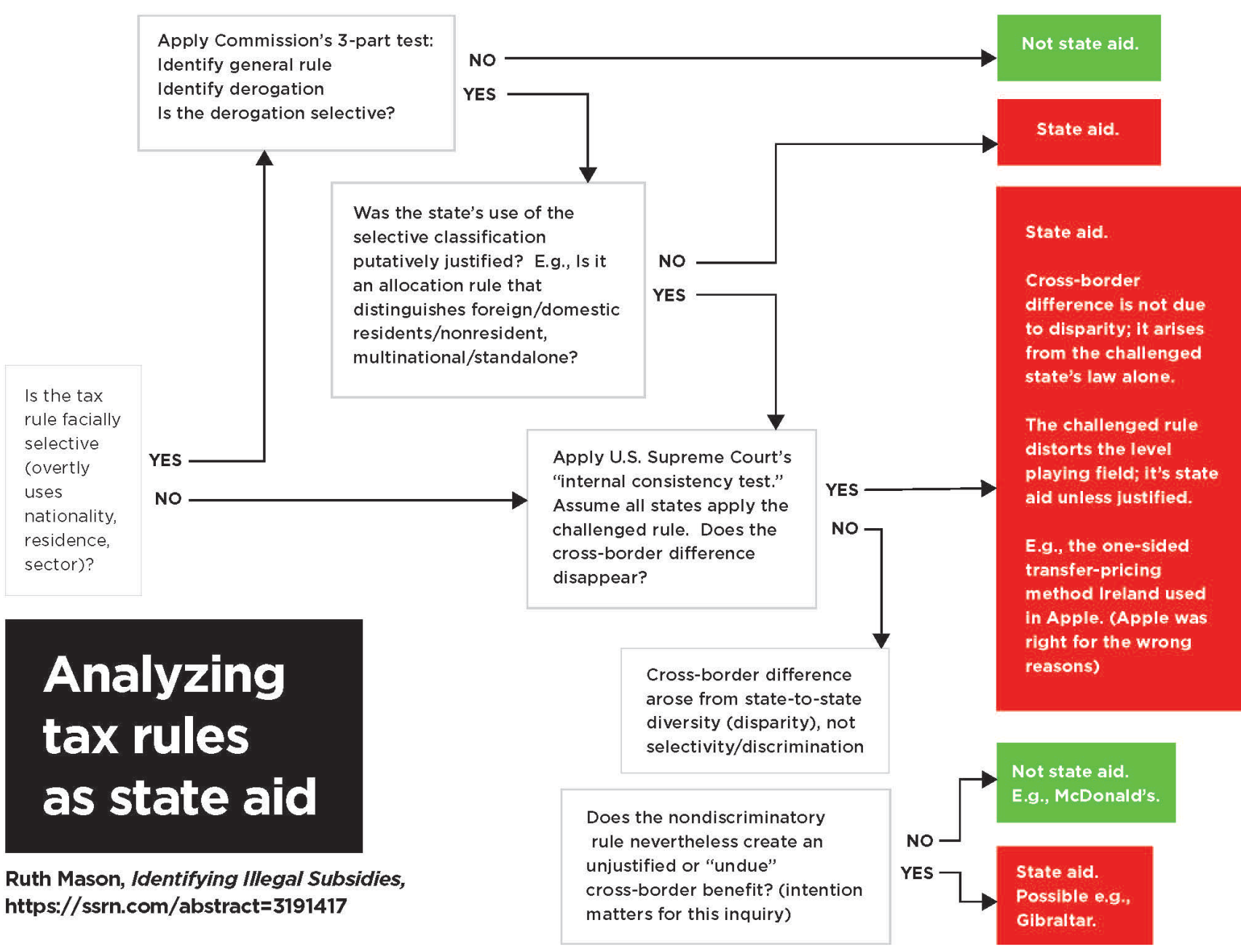


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Analyzing tax rules as state aid

Ruth Mason, *Identifying Illegal Subsidies*, <https://ssrn.com/abstract=3191417>

Tax Rulings as State Aid FAQ

by Ruth Mason



Ruth Mason

Ruth Mason is a professor of law at the University of Virginia School of Law. She thanks Werner Haslechner, Mitchell Kane, Tracy Kaye, Georg Kofler, Raymond Luja, John Roper, Stephen Shay, and participants at the U. Va. autumn Invitational Tax Conference for their helpful comments. She is particularly grateful to Lily Faulhaber for discussing the issues and reading multiple drafts. Lee Barkley and Stefanie Jackson provided valuable research assistance.

In this report, the first in a series of reports on EU state aid, Mason provides background on state aid law as it applies to income taxes.

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On August 30, 2016, the European Commission announced its decision that Ireland granted illegal

state aid to Apple Inc.¹ The European Union’s state aid rules constrain how member states may subsidize businesses. The rules entitle the commission to order a member state that provides an illegal subsidy to recover the subsidy from the advantaged enterprise. The commission’s Apple decision came with a shocking price tag: Apple must repay roughly €13.4 billion — plus interest — to Ireland.

This report provides background for Americans on EU state aid law.

What Are the Governing Authorities?

Article 107 of the Treaty on the Functioning of the European Union prohibits state aid, with some exceptions.² Article 108 obliges the commission, the EU’s executive body, to monitor permissible aid and take enforcement actions against states granting impermissible aid. Article 108 also empowers the commission to determine whether a state has granted aid, subject to review by the EU courts. Article 109 allows the EU Council to promulgate state aid regulations.³ The TFEU “duty of loyal cooperation” obliges the member states to cooperate with commission investigations.⁴

The most important state aid legislation is council regulation 2015/1589.⁵ The regulation binds the commission and the member states, and it governs state aid procedures. The commission is also bound by enforcement policies and guidelines it has drawn up for itself. The most relevant guidelines for tax rulings were originally provided in a 1998 notice.⁶ (The guidelines survive with amendment

¹Commission press release on Apple decision, IP/16/2923 (Aug. 30, 2016).

²TFEU art. 107(1), 2007 O.J. (C 326) 91 (Oct. 26, 2012).

³TFEU art. 109 (the commission has to propose, and the EU Parliament has to approve, that regulation).

⁴TFEU art. 4(3) (duty of loyal cooperation).

⁵Council reg. 2015/1589 (July 13, 2015), providing detailed rules for the application of TFEU art. 108, 2015 O.J. L 248/9 (codification), superseding council reg. 659/1999 (Mar. 22, 1999), establishing detailed rules for the application of art. 93 of the EC Treaty, 1999 O.J. L 83/1. Under EU law, a regulation is legislation, meaning it was passed by the council, with approval by the Parliament, when necessary.

⁶Commission notice on application of the state aid rules to measures concerning direct business taxation, 1998 O.J. C-384/03, para. 9 (Dec. 10, 1998) (1998 notice). The 1998 notice was repealed and superseded by the 2016 notice on the notion of state aid.

and augmentation in the commission's 2016 notice.⁷) In the 2016 notice, the commission announced its interpretation of the TFEU requirements concerning state aid, as informed by its own past enforcement actions and decisions by the EU courts.

What Is State Aid?

The TFEU forbids states aid using the following language:

Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.⁸

Originally designed to prevent protectionism, over time the scope of the state aid prohibition has expanded, and now, it embraces a stance against harmful tax competition. Recent statements by commission officials⁹ suggest that the state aid rules enforce the single-tax principle, which is the idea that all of a multinational's income must be taxed exactly once.

To put it mildly, the unclear normative underpinnings for the state aid prohibition have made state aid enforcement unpredictable in the tax area.

The TFEU provides various exceptions to the state aid prohibition, including measures that respond to natural disasters and other exceptions unanimously agreed upon by the EU's Council of Ministers.¹⁰ Those agreed exceptions cover aid granted to raise the standard of living in lesser-developed regions and aid granted in response to the financial crisis. States also can seek advanced approval from the commission to enact specific kinds of subsidies.

The current tax ruling cases involving U.S. multinationals all involve putative "unnotified aid" that has not been preapproved by the commission.

⁷Commission notice on the notion of state aid as referred to in TFEU art. 107(1), O.J. C 262/1, at para. 74 (July 19, 2016) (2016 notice).

⁸TFEU art. 107(1).

⁹See, e.g., speech by EU Competition Commissioner Margrethe Vestager to the European Parliament's TAXE II special committee on tax rulings, at 2 (Apr. 4, 2016) (noting that of 2,000 rulings examined by the commission, "around 100 . . . look at just one side of a transaction. They decide on an appropriate profit for the activities of just one company of a group. As for the profit that remains, it might be taxed somewhere else — or it might not be taxed at all. This creates a potential for loopholes.").

¹⁰TFEU art. 107(2)-(3).

There are five elements to an illegal state aid. There must be (1) an advantage (2) granted by a member state (3) to an undertaking. The advantage must be granted (4) selectively, and it must (5) distort trade or competition in the internal market.¹¹ Under the current state of development of EU law, tax subsidies easily satisfy all the elements except for advantage and selectivity, so those are the only elements I will discuss here.¹²

What Is an 'Advantage'?

Under EU law, the concept of advantage clearly encompasses tax benefits, but it does not encompass mere legal certainty.¹³ As a result, ordinary confirmatory rulings do not constitute aid,¹⁴ but rulings that reduce taxes could be aid.

The commission often identifies advantages using the market economy operator test.¹⁵ This test analyzes a member state's investment in an enterprise and asks "whether, in similar circumstances, a private investor of a comparable size operating in normal conditions of a market economy could have been prompted to make the investment" on the same terms.¹⁶ This test works well when the advantage is a loan or equity infusion made by a state, but it does not directly translate into government activities that are never performed by private investors, such as granting tax rulings.

In a recent tax state aid case, *Adria-Wien*, the EU's highest court, the Court of Justice, stated:

The concept of aid is more general than that of a subsidy. It embraces not only positive benefits, but also measures which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without therefore being subsidies in the strict meaning of the word, are similar in character and have the same effect.¹⁷

¹¹See, e.g., joined cases C-393/04 and C-41/05, *Air Liquide Industries Belgium SA*, 2006 E.C.R. I-5293, para. 28.

¹²See, e.g., commission decision initiating the formal investigation in SA.38373 (alleged aid to Apple), O.J. 2014/C 369/04, at para. 48 (Oct. 17, 2014) (noting that if the commission can show selective advantage, satisfaction of the other state aid elements is "relatively straightforward").

¹³2016 notice, *supra* note 7, at paras. 169-170.

¹⁴*Id.* at paras. 169 and 174.

¹⁵This approach, and others similar to it, have been accepted by the EU courts. See, e.g., case C-39/94, *SFEI and Others*, 1996 E.C.R. I-3547, paras. 60-62 ("to determine whether a State measure constitutes aid, it is necessary to establish whether the recipient undertaking receives an economic advantage which it would not have obtained under normal market conditions").

¹⁶2016 notice, *supra* note 7, at para. 74.

¹⁷Case C-143/99, *Adria-Wien Pipeline GmbH and Wietersdorfer and Peggauer Zementwerke GmbH v. Finanzlandesdirektion für Karnten*, 2001 E.C.R. I-8365, para. 38.

In *Adria-Wien* and other cases, the Court of Justice confirmed that tax reductions can constitute state aid. Similarly, in the 1998 notice, the commission described illegal tax state aid this way:

Firstly, the measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. The advantage may be provided through a reduction in the firm's tax burden in various ways, including:

- reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements or the entering of reserves on the balance sheet),
- total or partial reduction in the amount of tax (such as exemption or a tax credit),
- deferment, cancellation, or even special re-scheduling of tax debt.¹⁸

This description will remind U.S. readers of tax expenditures. As early as 1974, the Court of Justice established that tax expenditures could be state aid. In the *Italian Textile Case*, Italy argued that because a tax reduction was not a state aid, Italy did not violate the treaty when it excused the Italian textile industry from social security contributions. The court rejected that argument, declaring that the form of the aid did not matter.¹⁹ The court's ruling in the *Italian Textile Case* highlighted the anti-protectionist goal that dominated state aid at that time.²⁰

The basic idea is that if the state forgoes tax that otherwise would be due under its regular tax regime, that forgone tax is an advantage conferred on the taxpayer and, if granted selectively, a state aid. The 1998 notice made clear that the state aid concept also applies to actions taken by the tax administration:

Every decision of the administration that departs from the general tax rules to the benefit of individual undertakings in principle leads to a presumption of State aid.²¹

¹⁸1998 notice, *supra* note 6, at para. 9.

¹⁹Case 173/73, *Italian Republic v. Commission*, 1974 E.C.R. 709. Similarly, in a more recent case, the court stated that "a measure by which the public authorities grant to certain undertakings a tax exemption which, although not involving a transfer of state resources, places the persons to whom the tax exemption applies in a more favorable financial situation than other taxpayers constitutes State aid within the meaning of . . . the Treaty." Case C-387/92, *Banco Exterior de Espana v. Ayuntamiento de Valencia*, 1994 E.C.R. I-877, at para. 14.

²⁰The court noted that "the Italian textile industry is in competition with textile undertakings in other Member States." Case 173/73, *Italy v. Commission*, 1974 E.C.R. 709, para. 19.

²¹1998 notice, *supra* note 6, at para. 22.

Again, the "departure" language probably evokes tax expenditures for many U.S. readers.

We are all familiar with the baseline problem in identifying tax expenditures. If tax expenditures are deviations from a normative (or reference-law) baseline, we need to be able to identify the baseline to determine if a particular provision constitutes a deviation. In the U.S. domestic context, the consequence of labeling an item a tax expenditure is that its revenue cost has to be estimated and reported. In Europe the stakes are considerably higher. If a state enacts an improper tax expenditure, the commission can order the state to recover it from the taxpayer.

In EU tax state aid cases so far, the state's own regularly applicable tax regime, however defined, has served as the baseline.²² Proper identification of the reference base will be a major issue in the appeals in the recent cases. For example, if a state adopts the OECD transfer pricing guidelines as authoritative for transfer pricing rulings, do the guidelines become part of the reference baseline? If so, does adherence to the guidelines immunize the member state from state aid claims? The commission's final decision in the Starbucks case says no,²³ but this issue will be litigated.

What Is 'Selectivity'?

Selectivity doctrine is characterized by several different standards, and the application of those standards by the commission and the EU courts seems ad hoc. Selectivity likely will be another main contention in the appeals involving U.S. multinationals.²⁴

The commission has long maintained that an advantage conferred by a state is selective unless it applies "without distinction to all firms and to the production of all goods."²⁵ Thus, a low tax rate that applies uniformly to all taxpayers is not selective.²⁶ Likewise, tax ruling practice that merely confirms

²²This reference-base approach is similar to the one the Joint Committee on Taxation described in a 2008 report. JCT, "A Reconsideration of Tax Expenditure Analysis," JCX-37-08, at 9 (May 12, 2008) ("Our determination of Tax Subsidies in most cases thus is made, not by reference to an alternative and hypothetical 'normal' tax chosen by the JCT Staff, but rather by reference to the face of the Internal Revenue Code itself (along with its legislative history and similar straightforward tools for identifying legislative intent).")

²³*On State Aid Implemented by the Netherlands to Starbucks*, Commission Decision COMP/SA.38374 (Oct. 21, 2015), para. 264 (Starbucks final commission decision).

²⁴See, e.g., Case T-760/15, *Dutch Annulment Action in Starbucks* (pleading that "the Commission did not adequately — and separately — demonstrate that the selectivity criterion was fulfilled").

²⁵1998 notice, *supra* note 6, at para. 13.

²⁶2016 notice, *supra* note 7, at paras. 126-128.

the application of domestic law to the taxpayer's facts does not amount to a state aid, even if only some parties seek rulings.²⁷

Commission guidance provides that generally applicable provisions “of a purely technical nature” (like depreciation rules) and “measures pursuing general economic policy objectives” (like research and development incentives) will not be regarded as incentives.²⁸ But to avoid characterization as state aid, those advantages must be available to all companies.

State aid expert Raymond H.C. Luja, a professor at Maastricht University, recently identified a non-exhaustive list of selective advantages:

- (i) benefits applicable to a particular sector of industry (sectoral aid), (ii) benefits applicable to a certain region of the territory the government competent to tax (regional aid), (iii) benefits conditional upon exporting goods or services (export aid), (iv) individual benefits (like rulings that are too advantageous compared to case law and general tax policy), and (v) benefits in size (such as using thresholds that effectively restrict tax benefits to large companies).²⁹

Selectivity is a contentious legal issue in tax state aid enforcement actions. The lower EU court, the General Court, has annulled a series of recent commission tax decisions because the commission failed, in the General Court's view, to carry its burden on selectivity.³⁰ Preliminary indications from the Court of Justice, which hears appeals from the General Court, show a divergence of views among advocates general on the direction the doctrine should take.³¹

²⁷*Id.* at paras. 169 and 174.

²⁸See 1998 notice, *supra* note 6, at para. 13 (old guidance describing as not selective generally available rules on tax rates, depreciation, loss carryovers, provisions to prevent double taxation or tax avoidance, and generally available measures aimed at “certain production costs, including R&D, the environment, training, [and] employment”).

²⁹Luja, “EU State Aid Control: Balancing Tax Benefits and Fair Competition in Pursuit of an Internal Market,” in *Comparative Fiscal Federalism*, section 5.03(c) (2d ed. 2016).

³⁰See, e.g., joined cases T-515/13 and T-719/13, *Spain v. Commission* (Spanish leasing cases), para. 178 (annulling commission state aid decision on selectivity grounds because the tax advantage was available to all undertakings).

³¹Advocates general are Court of Justice members, but they do not decide cases. It is “the duty of the Advocate-General, acting with complete impartiality and independence, to make, in open court, reasoned submissions on cases which . . . require his involvement.” TFEU art. 252. The opinion of the advocate general is generally available well before the decision of the Court of Justice, and although not legally binding, the court follows that opinion in about 80 percent of cases. Georg Kofler

(Footnote continued in next column.)

It suffices here to indicate that fundamental issues remain unresolved, and there are important pending cases that will be decided before the appeals in the recent transfer pricing cases involving U.S. multinationals. A crucial question is whether rulings are selective because they are available to multinational groups but not to stand-alone companies.³² Another is whether transfer pricing rulings are automatically selective because they are issued to a particular taxpayer. Endorsement by the EU courts of such broad conceptions of selectivity would make any transfer pricing ruling that resulted in tax savings illegal aid, essentially vitiating selectivity as a separate criterion in rulings cases.

The forthcoming second part of this report will address whether tax rulings are selective. The short answer is that some are and some aren't.

What Is the Procedure?

EU law requires member states to seek the commission's permission before providing aid to enterprises. That did not happen for the rulings provided

and Ruth Mason, “Double Taxation: A European ‘Switch in Time?’” 14 *Colum. J. Eur'n L.* 63, 74, n.62 (2007).

The two advocates general who write the most tax opinions have divergent views on selectivity. Compare joined cases C-20/15 P and C-21/15 P, *Commission v. World Duty Free Group*, formerly Autogrill España SA (opinion of advocate general Wathelet), para. 7 (arguing that “once a tax measure derogates from the ‘normal’ or reference tax regime and benefits undertakings performing the transactions in question to the detriment of others that perform similar transactions and are therefore in a comparable situation, that measure is by definition discriminatory or selective, unless the differentiation created by the measure is justified by the nature or general scheme of the system of which it forms part”), with case C 66/14, *Finanzamt Linz v. Bundesfinanzgericht, Aussenstelle Linz* (opinion of advocate general Kokott), para. 81 (“the mere fact that a tax regime grants an advantage only to those undertakings which satisfy its conditions is not in itself capable of establishing its selectivity. On the other hand, a tax regime also cannot always be said not to be selective on the ground that all economic operators are able without distinction to avail themselves of the tax advantage which it makes available, provided that they satisfy its conditions. For, in that event, a tax regime would always have to be deemed not to be selective” (citations omitted)).

³²Starbucks final commission decision, *supra* note 23, para. 236. Letter from Vestager to Treasury Secretary Jacob Lew, at 2 (Feb. 29, 2016) (explaining that “under EU state aid rules Member States cannot give multinational groups a more favorable tax treatment than standalone companies”). See also Luja, “EU State Aid Law and National Tax Rulings: In Depth Analysis for the TAXE Special Committee,” IP/A/TAXE/2015-02, at 9-11 (2015) (concluding in a report to the EU Parliament's TAXE committee that the commission's view is that “that a de jure requirement of being internationally active would suffice to meet the selectivity criterion,” but noting recent EU General Court decisions holding that the fact that a state required a cross-border element before conferring an advantage did not automatically make the regime selective).

to Apple, Starbucks, Amazon, and others. For that so-called unnotified aid, the following investigatory procedure applies.

If the commission suspects that a member state granted state aid, it engages with the member state in a confidential exchange of information that allows the commission to make a preliminary assessment. After gathering more information, the commission could conclude that there was no aid and end the investigation. In the alternative, in the second step, the commission would make public (in the official journal) its investigation, allowing all interested parties to submit comments. The member state has one month to respond.³³ There is no deadline for the commission to complete its investigation.³⁴

The commission has incredibly broad investigatory powers. The regulation empowers the commission "to obtain all necessary information enabling it to take a decision" on state aid.³⁵ The commission can compel information not only from the accused member state but also from competitors and other member states, which could help the commission establish comparables in a transfer pricing case.³⁶ For example, in reaching its final decision in the Starbucks case, the commission sought and received information about comparables, business organization, and business practices from Starbucks competitors, including Nestle and Melitta. The appropriate use of information available to the commission but not the taxing state may be litigated in the Dutch appeal of the commission's Starbucks decision.³⁷

If the commission decides that the member state granted illegal state aid, the member state, the aided enterprise, or both can appeal the decision to the General Court and ultimately to the Court of Justice.³⁸ Whereas the commission gives an estimate of the state aid that must be recovered, it is up to the member state to calculate the exact amount in line with the commission's decision.³⁹

³³Council reg. 2015/1589, art. 6.

³⁴Council reg. 2015/1589, art. 15.

³⁵Council reg. 2015/1589, preamble, paras. 9 and 24.

³⁶See council reg. 2015/1589, art. 7.

³⁷One of the Netherlands's pleadings in its action to annul the commission's decision in the Starbucks case alleges that "the Commission did not assess and include all the relevant information in the decision and also uses as a basis anonymous information, or at least information that has never been shared with the Netherlands Government." Case T-760/15, Action to Annul Commission Decision SA.38374.

³⁸Council reg. 2015/1589, art. 7.

³⁹Notice from the commission toward an effective implementation of the commission decisions ordering member states to recover unlawful and incompatible state aid, 2007 O.J. C 272/05, paras. 48-50 (2007 notice on recovery).

Does the Taxpayer Participate?

Formally, the state aid investigation is against the member state, not the enterprise. Thus, the commission's decision is against Ireland, not Apple. The enterprise participates by responding to information requests from the commission and making arguments in the formal investigation phase.⁴⁰ Any member state can participate formally in the investigation, in a supportive or adversarial capacity. For example, Ireland regularly intervenes in support of other member states battling with the commission.⁴¹ Once the commission decides that a state has granted illegal aid, the state or the undertaking (or both) can appeal.

What Is the Recovery?

This one's a doozy. The regulation expects the commission to order the member state to recover the aid (that is, the tax savings plus interest⁴²) from the enterprise, and the offending state keeps the recovery.⁴³ The recovery period stretches back 10 years.⁴⁴ The unusual state aid recovery mechanism has its origins in judicial doctrine⁴⁵ that has since been codified.⁴⁶

Because the idea behind recovery is to put the enterprise and the member state in a position as if the aid had never been granted,⁴⁷ the measure of recovery is the amount of tax the enterprise would have paid absent the aid, plus interest. In calculating the recovery amount, the commission and the aiding member state ignore behavioral effects that denial of the aid might have had on the taxpayer. For example, the Apple recovery estimate assumes that Apple would have had the same activities in Ireland absent the putative tax aid.

⁴⁰See, e.g., Starbucks final commission decision, *supra* note 23 (reviewing Starbucks's arguments).

⁴¹See, e.g., case C-106/09, *Commission v. Gibraltar*, 2011 E.C.R. I-1113, para. 28.

⁴²The measure of the recovery is the difference "between the tax actually paid and the amount which should have been paid if the generally applicable rule had been applied." 1998 notice, *supra* note 6, at para. 35.

⁴³Council reg. 2015/1589, preamble para. 25, art. 16.

⁴⁴Council reg. 2015/1589, art. 17(1). The recovery period can be longer than 10 years because it also includes the period from when the commission first contacts the member state to gather information and extends to when the case concludes.

⁴⁵Case 70/72, *Commission v. Germany (Kohlegesetz)*, 1973 E.C.R. 813, para. 13 (holding that if the commission had the power to alter or eliminate the aid, it must have the lesser included power to recover it).

⁴⁶Council reg. 2015/1589, art. 16.

⁴⁷This explanation is unpersuasive, given that the measure of recovery is the amount of tax the enterprise would have paid to the aiding state if the aid provision not been in place. But by assumption, nothing else changes. Thus, the recovery calculation assumes that Apple would have had the same activities in Ireland even absent favorable tax treatment.

A major issue for U.S. multinationals, and a bone of contention for Treasury, has been whether the recovery will be regarded for U.S. law purposes as a creditable tax.⁴⁸

Many aspects of the recovery give pause to observers in the United States.

First, the recovery is from the taxpayer, but the taxpayer is not formally a party to the investigation. As a result, the taxpayer cannot directly defend itself, although, as an interested party, it is entitled to submit comments to the commission. Once the commission concludes its investigation, the taxpayer can file its own appeal, so eventually there is the kind of adversarial procedure we are accustomed to in tax litigation in the United States. The accused member state might join the taxpayer's appeal or file its own. Other interested parties can appeal the decision as well — for example, competitors could appeal a commission decision not to seek recovery upon a finding of state aid. The procedural safeguards for multinationals during the investigatory period seem inadequate, considering that companies can suffer significant reputational harms from adverse commission decisions, even if those decisions are ultimately vacated by the EU courts.

Second, the recovery period is 10 years, which exceeds the domestic statute of limitations for tax in most countries. Under EU law, expiration of the domestic statute of limitations does not constitute an adequate defense for failure to recover, as will be discussed next.⁴⁹

Third, the taxpayer remits the penalty to the very state that violated EU law by granting the subsidy. Even if it were generally agreed that imposing liability on the taxpayer makes sense — either because disgorgement serves the market goals underlying the state aid rules or from a deterrence perspective — it is not clear that the recovery should go to the state that violated EU law by granting the aid. As Michael Graetz has pointed out, the recovery seems to reward the state for actions contrary to EU law.⁵⁰ Under current rules, a state that poaches business from other states by

delivering illegal subsidies ultimately may receive reimbursement of that illegal subsidy.

To put it differently, even if it's clear that Apple should pay, why should Ireland receive anything? Although EU officials are aware of this issue, the most common proposal to fix it — allowing the commission to keep the recovery — raises serious moral hazards.⁵¹

Another alternative might be to spread the recovery across the higher-tax states from which income was shifted with the help of the offending tax ruling. The commission press release announcing the final decision against Ireland in the Apple case noted that information revealed in the commission's final decision might lead other member states or even the United States to collect back taxes from Apple. The commission stated that if other states enforced those collections now, the new collections would reduce Apple's recovery obligation in Ireland.⁵² Although this kind of indirect transfer of the recovery to other states might result in taxation more consistent with economic reality, it raises an important legal question about how the commission can establish that Ireland granted state aid to Apple by failing to collect taxes if those taxes actually should have been paid to some other state.

Are There Any Exceptions to Recovery?

Under EU rules, the obligation to recover trumps most domestic laws that stand in the way. The state is excused from recovering the aid only when recovery is “absolutely impossible,” for example because the aided enterprise liquidates or because recovery would violate the state's constitution.⁵³ That the recovery merely would violate the state's statute of limitations or other domestic recovery rules does not excuse recovery.⁵⁴ If the state has a constitutional prohibition on retroactive taxation, the commission would expect the state to recover

⁴⁸See Mindy Herzfeld, “Is the EU a Country?: Creditability of State Aid,” *Tax Notes Int'l*, Sept. 19, 2016, p. 1004.

⁴⁹See 2007 notice on recovery, *supra* note 39, para. 20 (noting that the EU courts have not accepted recovery defenses concerning the domestic statute of limitations). Commentators have suggested requiring member state legislation that would ensure recovery in state aid cases. See Luja, TAXE report, *supra* note 32, at 21.

⁵⁰“The governments may appeal the EC's determinations in the European courts, but if they lose, they still win.” Graetz, “Behind the European Raid on McDonald's,” *The Wall Street Journal*, Dec. 3, 2015 (criticizing the commission's investigations for lack of procedural protections).

⁵¹Luja, TAXE report, *supra* note 32, at 21 (“State aid law as it stands today does not provide for a legal basis to withhold any part of the windfall benefit enjoyed by the Member State. No part of the recovered amount flows to the Union's resources. Introducing an obligation for a Member State to hand off part of amounts recovered to the EU might require a change of the Treaties, which is rather infeasible.”).

⁵²Commission's press release on its Apple decision, *supra* note 1, at 3-4.

⁵³2007 notice on recovery, *supra* note 39, at para. 20 (“Community Courts have interpreted the concept of ‘absolute impossibility’ in a very restrictive manner.”).

⁵⁴See, e.g., case C-232/05, *Commission v. French Republic*, 2006 E.C.R. 71, para. 36 (finding that national rules suspending recovery requirements during appeals could not be used to justify failure to recover state aid).

the tax in a form other than a retroactive tax (for example, by levying a penalty).⁵⁵

The Court of Justice has excused recovery in cases in which the commission conferred on an enterprise the “legitimate expectation” that there was no aid.⁵⁶ The Court of Justice interprets this standard to be fulfilled only when a community institution — not a member state — creates the legitimate expectation.⁵⁷ The standard applies, for example, when the commission unreasonably delays its aid decision⁵⁸ or when the commission preapproved an aid that it later decided was unlawful (either because the commission changed its view or because the state administered the aid improperly or expanded it).⁵⁹ In the Court of Justice’s view, a diligent business person should be able to determine if his undertaking received aid and, if so, whether the state notified the commission of the aid and secured its approval.⁶⁰

Just because recovery is legally required, however, does not mean that it will take place quickly.

⁵⁵Case C-183/91, *Commission v. Greece*, 1993 E.C.R. I-3131, para. 17 (“it is not correct to argue . . . that recovery of the aid in question must necessarily take the form of a retroactive tax. . . . [T]he Greek authorities merely have to take measures ordering the undertakings which have received the aid to pay sums corresponding to the amount of the tax exemption unlawfully granted to them.”).

⁵⁶Commission decision 2003/512/EC (German coordination centres), 2003 O.J. L. 177/17, para. 43.

⁵⁷Joined cases C-182/03 and C-217/03, *Belgium and Forum 187 v. Commission*, 2006 E.C.R. I-5479, para. 147 (“the right to rely on the principle of the protection of legitimate expectations extends to any person in a situation where a Community authority has caused him to entertain expectations which are justified. However, a person may not plead infringement of the principle unless he has been given precise assurances by the administration.”).

⁵⁸Case 223/85, *RSV v. Commission*, 1987 E.C.R. I-4617 (recipient of unnotified aid successfully challenged recovery order when the commission did not explain why it delayed for 26 months in adopting its decision on the alleged aid).

⁵⁹German coordination centres commission decision, *supra* note 56, at para. 43; see also commission decision 2004/76/EC (French headquarters and logistics centres), 2004 O.J. L. 23/1, paras. 82-83; and commission decision 2004/77/EC (Belgian tax ruling system for U.S. foreign sales corporations), 2003 O.J. L. 170/20, paras. 74-78.

⁶⁰Joined cases C-182/03 and C-217/03, *Belgium and Forum 187 v. Commission*, 2006 E.C.R. I-5479, para. 147. See also opinion of advocate general Jacobs at para. 73 in case C-39/94, *Syndicat Francais de l’Express International v. La Poste*, 1996 E.C.R. I-3547 (arguing that legitimate expectation could arise when the contested provision was not obviously aid, and when the commission upon preliminary inquiry decided not to pursue an aid investigation and then took three years to decide that there was aid). Under Jacobs’s conception, the commission’s failure to investigate tax rulings earlier would not appear to be sufficient to create a legitimate expectation of no aid, especially when it is unclear whether the commission had reason to know whether secret rulings conferred selective aid.

The EU annually reports on outstanding aid that has not been recovered.⁶¹ The member states regularly miss recovery deadlines.⁶² Although Apple is not expected to refuse to comply, if a taxpayer drags its feet on recovery, the commission has some collateral enforcement options short of bringing suit in the EU courts. For example, under EU rules, the commission can order a state to deny approved aid to an enterprise that has not made its recovery payment from an earlier case.⁶³ Monetary penalties can also be imposed on member states for failure to recover.⁶⁴

Filing an appeal does not suspend the taxpayer’s obligation to repay the aid with interest.⁶⁵ In practice, this means that Apple’s 13.4 billion euros will remain in escrow as Ireland’s appeal and its own appeal go forward.⁶⁶

Is State Aid New?

There is nothing new about state aid, about state aid investigations of corporate tax practices, or even about state aid investigations of tax rulings. What I think is new is the commission’s decision to investigate member states for rulings issued to particular companies rather than reviewing a member state’s ruling practices more generally. Also, although member states have been forced to recover state aid before (including tax state aid), the commission has never sought recovery on the scale of the Apple case. The recovery mechanism is strange, but there is nothing new or secret about it, and it comes as no surprise to anyone reasonably informed about EU law.

State aid was outlawed as early as the 1951 Treaty of Paris establishing the European Coal and Steel Community, and the prohibition has existed in its current form since the Treaty of Rome entered into force in 1958.⁶⁷ The European Commission has actively applied the state aid rules in all areas of market regulation since the 1970s.

⁶¹See European Commission, “State Aid Scoreboard 2015.”

⁶²2007 notice on recovery, *supra* note 39, at para. 3 (“Experience shows that there is practically not a single case in which recovery was completed within the deadline set out in the recovery decision.”). See also *id.* (“Recent editions of the State aid Scoreboard also show that 45 percent of all recovery decisions adopted in 2000-2001 had still not been implemented by 2006.”).

⁶³See 2007 notice on recovery, *supra* note 39, at para. 75 (describing the so-called Deggendorf principle).

⁶⁴2007 notice on recovery, *supra* note 39, at paras. 72-74 (describing procedure).

⁶⁵The president of the General Court can suspend the recovery pending appeal. Council reg. 2015/1589, art. 17.

⁶⁶See commission’s release on its Apple decision, *supra* note 1.

⁶⁷Treaty establishing the European Coal and Steel Community (Treaty of Paris), art. 4(c) (Apr. 18, 1951); and treaty establishing the European Economic Community (Treaty of Rome), art. 92(1) (Mar. 25, 1957).

The commission's focus on corporate taxation began in the late 1990s as part of the EU's Code of Conduct push. The Code of Conduct on business taxation was the EU's counterpart to the OECD's Project on Harmful Tax Practices. Adopted in 1997, the Code of Conduct set out factors for identifying harmful tax practices, and it requires member states to abolish those measures and refrain from adopting them in the future.⁶⁸

A problem with the Code of Conduct was that it had no enforcement mechanism.⁶⁹ As part of the code, however, the EU Council⁷⁰ took note that tax measures that violated the Code of Conduct might violate the TFEU prohibition on state aid, and the council further noted the commission's intention to publish guidance on tax state aid after submitting draft guidelines to the member states. Also, the council noted that the commission "commits itself to the strict application of the state aid rules concerned."⁷¹

Thus, the council, which for this purpose would have been composed of the finance ministers of the member states, sanctioned the commission's strategy to examine Code of Conduct violations as possible state aid. Code violations are identified through a formal process involving the EU's Code of Conduct group.⁷² For its part, the commission fleshed out that strategy in the 1998 notice.⁷³

This approach by the commission had at least two strategic advantages. First, it provided an enforcement mechanism for the otherwise toothless Code of Conduct. Second, by investigating regimes

⁶⁸See Resolution of the Council and the Representatives of the Governments of the Member States, Meeting Within the Council, of 1 December 1997 on a Code of Conduct for Business Taxation, 1998 O.J. (C 2) 2, 2 (Code of Conduct).

⁶⁹*Id.* at 3 ("the code . . . is a political commitment and does not affect the Member States' rights and obligations . . . from the Treaty").

⁷⁰For this purpose, composed of the finance minister of each member state.

⁷¹Code of Conduct, *supra* note 68, at 5.

⁷²See 1998 notice, *supra* note 6, at para. 1 ("State aid provisions of the Treaty will also contribute through their own mechanism to the objective of tackling harmful tax competition."). See, e.g., commission decision 2003/755/EC (Belgian coordination centers), 2003 O.J. L 282/25, para. 1 (noting that the instant case was brought because "the Commission, acting in accordance with the state aid rules, began its examination of the measures identified by the code of conduct group as harmful").

⁷³1998 notice, *supra* note 6, at para. 1 (noting that the commission's promulgation of guidelines for state aid in business taxation was motivated by the Code of Conduct). *Id.* at para. 30 ("The qualification of a tax measure as harmful under the code of conduct does not affect its possible qualification as a State aid. However the assessment of the compatibility of fiscal aid with the common market will have to be made, taking into account, *inter alia*, the effects of aid that are brought to light in the application of the code of conduct.").

that had already been identified as harmful in a multilateral process conducted by the member states themselves, the commission was able to enter the corporate tax state aid arena in a way that was relatively uncontroversial. Thus, the regimes initially targeted by the commission were at least putatively ones that the member states had already resolved to abolish under the Code of Conduct. The commission could thus establish the legitimacy of its enforcement authority in corporate tax cases without generating significant opposition from the member states.

Many of these cases involved rulings by member states confirming that taxpayers qualified for special low-tax regimes (such as coordination center regimes).⁷⁴ A difference between this earlier set of investigations that took place in the early 2000s and the current cases is that in the earlier investigations the commission looked at a state's ruling practices overall rather than focusing on rulings granted to a particular taxpayer. But analysis of a state's ruling practice necessarily involved analyzing rulings granted to particular taxpayers.

What we learned from this first spate of cases was that the commission found ruling practices to constitute impermissible state aid when those ruling practices clearly failed to conform with the OECD transfer pricing guidelines (for example, by allowing taxpayers to use a favorable fixed markup for cost-plus rather than conducting a particularized inquiry, or unreasonably allowing companies to ignore some costs when applying cost-plus⁷⁵). In other words, failing to adhere to the OECD standards — standards that the member state imported into its own domestic law — constituted aid.

We also learned the regime features that the commission found suspicious, including relief provisions with no sunset and no ceiling, rulings with

⁷⁴Commission, "Report on the Implementation of the Commission Notice on the Application of State Aid Rules to Measures Relating to Direct Business Taxation," C(2004)434 (business tax state aid implementation report). See also the commission's state aid and tax rulings website, which lists 15 cases between 2001 and 2006, available at http://ec.europa.eu/competition/state_aid/tax_rulings/index_en.html.

⁷⁵Belgian coordination centers commission decision, *supra* note 71 (reviewing a Belgian system granting U.S. companies with Belgian permanent establishments cost-plus transfer pricing rulings using fixed costs of 8 percent and also ignoring some costs). In its decision, the commission determined that companies consistently obtained better results under the Belgian ruling practice than were available under the regular Belgian tax regime. *Id.* at para. 90.

no expiration, and rulings with inadequate documentation.⁷⁶ The commission has objected to similar features in the recent cases. For example, in its notice to Ireland that it would commence the investigation in the Apple case, the commission noted that one of the rulings “was applied by Apple for fifteen years without revision.”⁷⁷ To provide context, the commission included a chart listing the typical duration of advance pricing agreements in other EU member states.⁷⁸ The commission also questioned the “appropriateness” of the pricing method used by Ireland for Apple because it did not account for “possible changes to the economic environment and required remuneration levels.”⁷⁹

In addition to announcing its strategy to investigate the regimes identified by the Code of Conduct group,⁸⁰ the 1998 notice marked an important difference in the commission’s stance on tax state aid. State aid enforcement was no longer just about protectionism or distortions to the internal market. Instead, the commission expressed concern about the allocation of tax revenue among the member states. In laying out its charter for future state aid enforcement actions, the commission stated:

Account must also be taken, in the common interest, of the major repercussions which some aid granted through tax systems may have on the revenue of other Member States.⁸¹

Other aspects of the 1998 notice previewed the current investigations. Among other tax practices, the 1998 notice specified that tax benefits restricted to intragroup activities and discretionary administrative practices, including tax rulings, could be state aid.⁸² The notice expressed special concern for

nontransparent administrative decisions.⁸³ The 1998 notice was superseded by the 2016 notice on the notion of state aid, but the 2016 notice adopts much of the 1998 notice.⁸⁴

Another banner year in the development of business tax state aid doctrine was 2012. That year marked so-called state aid modernization. Under this approach, the commission resolved to focus on the highest-impact cases, expressly including tax measures.⁸⁵

In the period between the mid-2000s and 2013, the commission stepped down its enforcement of tax state aid. In addition to a false sense of security engendered by this quiescent period, another reason that state aid seemed to Americans to come from nowhere is that the commission’s prior investigations mostly involved European, not American, companies.

How Does the Commission Pick Its Cases?

In contrast to the commission’s early foray into state aid enforcement, the commission’s efforts against transfer pricing rulings since 2013 have not had broad member state support, and there has been no agreed list of regimes to target.

The commission’s lack of transparency on how it selects state aid cases has fueled concerns that it selectively targeted U.S. multinationals. Treasury Secretary Jacob Lew’s letter to commission President Jean-Claude Juncker reflects these concerns.⁸⁶ Although Treasury’s white paper does not address this issue, U.S. observers presumably still have concerns about why U.S. multinationals appear to have been disproportionately targeted.

The commission does not publicly release its criteria for selecting cases. However, under the commission’s own rules, it must “examine without

⁷⁶Business tax state aid implementation report, *supra* note 74, at para. 4 (“Since there were relatively few tax aid cases before 2001, the Commission preferred to build up a larger body of experience before carrying out any review.”).

⁷⁷*Alleged Aid to Apple*, commission decision COMP/SA.38373, 2014 O.J. C 369/22, para. 65 (Apple opening decision).

⁷⁸Apple opening decision, *id.* at para. 45 (most states’ advance pricing agreements have maximum durations of five years or shorter).

⁷⁹*Id.* at para. 65.

⁸⁰The Code of Conduct group still exists; it monitors compliance with the code. In March 2016 the European Council (ECOFIN, consisting of the finance minister of each member state) resolved that the Code of Conduct group should reexamine the Code of Conduct criteria to support anti-BEPS measures. See European Council, 6900/16, FISC 35, ECOFIN 208 (Mar. 8, 2016).

⁸¹1998 notice, *supra* note 6, at para. 3.

⁸²*Id.* at paras. 20 and 22 (“Some tax benefits are on occasion restricted to certain types of undertakings, to some of their functions (intra-group services, intermediation or coordination) or to the production of certain goods. In so far as they favour certain undertakings or the production of certain goods, they may constitute State aid.”).

⁸³*Id.* at para. 22 (“As far as administrative rulings merely contain an interpretation of general rules, they do not give rise to a presumption of aid. However, the opacity of the decisions taken by the authorities and the room for manoeuvre which they sometimes enjoy support the presumption that such is at any rate their effect in some instances.”).

⁸⁴See 2016 notice, *supra* note 7. The 2016 notice had been released in draft form in 2014. The 2014 draft was substantially similar to the final 2016 notice. The 2016 notice also sets out the commission’s view of state aid doctrine — as informed by its prior decisions and court cases — and it binds the commission.

⁸⁵Communication from the commission to the European Parliament, the council, the European Economic and Social Committee, and the Committee of the Regions, EU State Aid Modernization (SAM), COM(2012) 209 final, at para. 19 (May 8, 2012) (SAM communication).

⁸⁶Lew letter to Juncker, at 2 (Feb. 11, 2016) (“DG COMP appears to be targeting U.S. companies disproportionately.”).

undue delay any complaint submitted by any interested party.”⁸⁷ Interested parties include member states, the putative aid recipient, and competitors of the putative aid recipient.⁸⁸ But we do not know if complaints were lodged in the recent cases.

Absent a complaint, the commission investigates according to its own discretion. Commission officials have openly admitted that politics and public opinion guided their investigation decisions. For example, Joaquín Almunia, outgoing vice president of the commission, said, “It is well known that some multinationals are using tax planning strategies to reduce their global tax burden. These aggressive tax planning practices erode the tax bases in our Member States.” He added that “when public budgets are tight, and citizens are asked to make efforts to deal with the consequences of the crisis, it cannot be accepted that large multinationals do not pay their fair share of taxes.”⁸⁹

The commission’s rules entitle it to investigate all state aid that it learns about from any source.⁹⁰ Thus, if commission staff followed the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (PSI) hearings on Apple in 2013, or if staff read then-Sen. Carl Levin’s memorandum on Apple, this arguably would have triggered an obligation to investigate. After being pressed by the PSI, Apple admitted that some of its most profitable subsidiaries were tax resident nowhere on earth, and they paid little tax to Ireland, where they were incorporated. As part of the hearings, the PSI released a memorandum in which it described Apple as having “negotiated [with Ireland] a special corporate tax rate of less than two percent.”⁹¹ Even though Apple and Ire-

land disputed that characterization,⁹² it would be surprising if reports of tax rate negotiations did not trigger alarms with the director-general of competition that Apple might be getting a sweetheart deal from Ireland.

Likewise, we can probably trace the commission’s investigations of Starbucks and Amazon to the U.K. House of Commons Committee of Public Accounts. Reading testimony, like the following exchange between Tory member of Parliament Stephen Barclay and Troy Alstead, Starbucks’s global CFO, would have put the commission on alert:

Barclay: What is the tax rate you pay in the Netherlands?

Alstead: I am very happy to provide that to the Committee, but I am bound by confidentiality to the Dutch Government on that. My request would be: could I follow up afterwards and provide it just to the Committee? I am very happy to do that — just confidential.

Chair: Confidential to whom?

Alstead: The tax authority, under our Dutch ruling, has asked us not to share that publicly. I will absolutely share it with the . . .

Barclay: You have just answered my next question, which was whether you have a Dutch tax ruling — you do.

Alstead: Yes, I do.

Barclay: You have a special arrangement to allow you to pay less tax in the Netherlands.

Alstead: Yes, it is a low-tax ruling that we have in place.

Barclay: And it is for that reason that you transfer the profits from the U.K., which are booked as losses in the U.K., into the Netherlands. Some of that then goes back to the States, but the rest of it pays a lower rate in the Netherlands under a Dutch tax ruling. That is correct, is it?⁹³

Dutch authorities later disavowed that they asked Starbucks to keep the ruling secret, and so did Starbucks,⁹⁴ but officials in the commission

⁸⁷Council reg. 2015/1589, art. 12(1). *See id.*, preamble para. 32 (“complaints are an essential source of information for detecting infringements of the Union rules on State aid”).

⁸⁸Council reg. 2015/1589, art. 1(h).

⁸⁹European Commission release, including statement by Almunia on the opening of three investigations on transfer pricing arrangements on corporate taxation of Apple (Ireland), Starbucks (the Netherlands), and Fiat Finance and Trade (Luxembourg) (June 11, 2014).

⁹⁰Council reg. 2015/1589, art. 12(1).

⁹¹*See* PSI, “Offshore Profit Shifting and the U.S. Tax Code — Part 2,” at 2 (May 21, 2013) (emphasis added). The PSI investigation revealed that one of Apple’s foreign affiliates, AOI, had 30 percent of Apple’s total worldwide net profits from 2009 to 2012, yet AOI did not pay any corporate income tax to any country in that period. *Id.* at 2 (describing Apple as shifting “billions of dollars in profits away from the United States and into Ireland”). Phillip Bullock, the tax operations head of Apple, told the PSI that Apple negotiated a special rate with Ireland. Apple CEO Tim Cook denied this claim in his own testimony. *Id.* at 20.

⁹²Associated Press, “Apple CEO Tim Cook Grilled on Irish Tax Scandal,” May 21, 2013 (“Irish Prime Minister Enda Kenny on Tuesday denied the assertion in the subcommittee’s report that Apple had negotiated an Irish corporate tax rate of less than 2 percent. ‘All companies pay the standard rate of 12.5 percent on profits from Irish operations,’ the prime minister said.”).

⁹³House of Commons, Comm. of Public Accounts, HM Revenue & Customs: Annual Report and Accounts 2011-12 (19th Rep. Sess. 2012-13), at EV 26 (Alstead testimony).

⁹⁴Starbucks amended Alstead’s testimony to include the following note: “To clarify, Mr. Alstead is referring to the mutual understanding of confidentiality relating to information shared

(Footnote continued on next page.)

might have been alerted by Alstead's testimony that something worth investigating might be going on between the Netherlands and Starbucks.

Amazon's director of public policy, Andrew Cecil, was called before the same U.K. committee, and he stonewalled them, leading members of the committee to remark that it was not credible that Cecil did not know the answers to the questions they were asking, which included the country-by-country profitability of Amazon and the identity of the owner of the Dutch entity that reported the lion's share of Amazon's European profits.⁹⁵ During the testimony, MPs described Cecil's answers as "totally evasive," "circuitous," "annoying [and] insulting to everyone's intelligence," "unacceptable," "incredible . . . and just not credible," and "ridiculous." At one point in the questioning, the committee's chair, Labour MP Margaret Hodge, concluded, "Cecil, you don't have anything. Honestly, you have come to me with absolutely no information. . . . The idea that you come here and simply do not answer the questions, and pretend ignorance, is just not on. It is awful."⁹⁶

While some of the hostility of the U.K. committee was attributable to political posturing, the entire hearing is worth reading as a list of "don'ts" when testifying before a public investigatory body.

So to an outside observer, it looks like the Senate's PSI and the U.K.'s Public Accounts Committee set the commission's agenda.⁹⁷ Several years after the initiation of the actions in the current set of

with and received from the Dutch tax authorities in our confidential but arm's length negotiations with them. We do not have a formal written confidentiality agreement with the Dutch tax authorities." Alstead testimony, *supra* note 93, at EV 26 n.6.

⁹⁵See *id.* at EV 33. In response to Cecil's claim that he did not know how much revenue Amazon had in the United Kingdom, MP Ian Swales said "You must be joking. Come on, you can't be serious." He continued, "I used to be a finance director of a pan-European business. If somebody asked me, 'What do you sell in each country?' I would be fired immediately if I did not have the answer to the question. That's ridiculous." Cecil backtracked in his next response, stating that although Amazon never released those figures publicly, he could provide them privately. *Id.*

⁹⁶See Alstead testimony, *supra* note 93, at EV 33-36.

⁹⁷According to the commission's website, "A dedicated Task Force Tax Planning Practice was set up in summer 2013 to follow up on public allegations of favourable tax treatment of certain companies (in particular in the form of tax rulings) voiced in the media and in national Parliaments." See European Commission, "State Aid-Tax Rulings," available at http://ec.europa.eu/competition/state_aid/tax_rulings/index_en.html. See also Johannes Laitenberger, "State Aid Tax Cases: Sine Timore Aut Favore," DG Competition, keynote address at St. Gallen International Competition Law Forum, at 4 (May 20, 2016) (confirming that the commission became interested in investigating rulings practices after "media reports and the parliamentary debates," specifically mentioning the United States and the United Kingdom).

cases, Director-General of Competition Johannes Laitenberger seemed to confirm the origin of the cases in a speech to a meeting of competition law specialists in Switzerland. Referring to the Senate and U.K. investigations, Laitenberger said, "The Commission regarded the media reports and the parliamentary debates of a few years back as market information. The Commission listened and decided to look deeper into the matter."⁹⁸ The recently released redacted version of the commission's final decision in the Apple case confirmed that the commission first learned about Ireland's rulings for Apple from the U.S. Senate hearings.⁹⁹

Readers may be wondering about the commission's investigation of Luxembourg's McDonald's and Fiat rulings.

While I do not know what triggered the McDonald's investigation (and that investigation involves a permanent establishment status ruling, not a transfer pricing or profits allocation ruling), just before the commission started its investigation, McDonald's was the subject of a report on tax avoidance by a coalition of U.S. and European labor groups.¹⁰⁰ The report received significant media attention.

Fiat is the only of the four recent transfer pricing rulings investigations that involved an EU-based multinational. Professor Werner Haslehner wrote a fascinating article on whether the commission had legal authority to compel Luxembourg to turn over its tax rulings, and his account included an explanation for how the Fiat case arose.¹⁰¹ The commission demanded that Luxembourg hand over all its rulings going back 10 years. Luxembourg refused to comply with the order, arguing that identity information about the taxpayers could not help the commission establish its state aid case. Instead, Luxembourg turned over a subset of rulings that it described as representative, and it redacted them to obscure the identities of the taxpayers. But Luxembourg failed to properly redact its ruling for Fiat,

⁹⁸Laitenberger, *supra* note 97.

⁹⁹Commission Decision initiating the formal investigation in SA.38373 (Alleged Aid to Apple), O.J. 2014/C 369/04 (Oct. 17, 2014) [hereinafter *Apple Final Decision*], at para. 440 ("the Commission could only have learnt of the existence of those rulings when their existence was publicly disclosed, which happened for the first time during hearings of the U.S. Senate").

¹⁰⁰See European Public Service Union, "Unhappy Meal: €1 Billion in Tax Avoidance on the Menu at McDonalds" (Feb. 24, 2015).

¹⁰¹Haslehner, "Advance Rulings and State Aid: Investigative Powers of the EU Commission (T-258/14)," in *ECJ — Recent Developments in Direct Taxation* (2014) (discussing the standard the commission has to meet before pursuing a state aid investigation).

which allowed the commission to identify the company and, according to Haslehner, led to its investigation.¹⁰²

Like the United States, Luxembourg claimed that the commission was engaged in selective prosecution. According to Haslehner, Luxembourg dropped that claim when the commission demanded in December 2014 that every EU state turn over all its rulings for the past 10 years.¹⁰³ That later development may have been partly in response to LuxLeaks, which in November 2014 released hundreds of Luxembourg tax rulings online.¹⁰⁴ Although the LuxLeaks disclosures occurred after the commission opened most of the recent state aid investigations, it may have contributed to political pressure on the commission, and it highlighted the role that tax rulings could play in harmful tax competition.¹⁰⁵

So how did the commission come to target four U.S. multinationals — and only one European multinational — in its recent ruling investigations? One possibility is discrimination: The EU commissioners targeted U.S. multinationals specifically because they are American. In a time of fiscal crisis, U.S. multinationals may be attractive revenue sources. Another possibility is that U.S. multinationals made up more of the pool of potential targets for the commission because U.S. multinationals were particularly aggressive or successful in securing favorable tax rulings. This would be consistent with evidence from LuxLeaks.¹⁰⁶ When the commission opened its state aid investigations, U.S. multinationals were being held up as prime examples of international tax avoidance, and news reports on

their activities contributed to the international outcry that led to the OECD and G-20 base erosion and profit-shifting project.¹⁰⁷

Another possibility is that the commission sought to send a clear message — to get bang for its buck — and investigating the largest companies in the world would accomplish this goal.¹⁰⁸ Some may be reminded of the IRS's decision to prosecute Wesley Snipes for tax evasion. Investigating larger and more serious state aid breaches also accords with the commission's best practices rules for dealing with state aid complaints.¹⁰⁹ Under these rules, the commission is free to prioritize complaints by, among other factors, the scope of the alleged infringement, the size of the beneficiary, the sector affected, and the existence of other complaints.¹¹⁰

Because the commission does not disclose how it picks its cases generally or how it came to investigate particular companies, we are left to speculate. Moreover, there is little formal regulation constraining the commission in its state aid investigations. The commission's rules require it to investigate all cases of suspected state aid, but limited resources make that impossible. Under commission rules¹¹¹ and the case law of the General Court,¹¹² the commission must follow the principle of equal treatment when applying its guidelines. At the same time, the commission "may on its own initiative examine information regarding alleged unlawful aid from whatever source."¹¹³ When public officials exercise broad discretion, they should expect to be held accountable for the manner in which they exercise it. To date, the commission has not provided a satisfactory answer to how it targets companies for state aid investigations. ■

¹⁰²See *id.* at 92.

¹⁰³European Commission press release, "State Aid: Commission Extends Information Enquiry on Tax Rulings Practice to All Member States," IP/14/2742 (Dec. 17, 2014).

¹⁰⁴Leslie Wayne and Kelly Carr, "Lux Leaks' Revelations Bring Swift Response Around World," International Consortium of Investigative Journalists (Nov. 7, 2014).

¹⁰⁵It also may partly explain why the commission opened its later investigation of the ruling granted to McDonald's by Luxembourg.

¹⁰⁶According to Omri Marian's analysis of the LuxLeaks rulings, more rulings were granted to U.S. companies than companies from any other state, and rulings issued to U.S. and U.K. companies comprised two-thirds of the sample. Marian, "The State Administration of International Tax Avoidance," 7 *Harv. Bus. L. Rev.* (coming); see also Allison Christians, "Lux Leaks: Revealing the Law, One Plain Brown Envelope at a Time," *Tax Notes Int'l*, Dec. 22, 2014, p. 1123.

¹⁰⁷OECD, Action Plan on Base Erosion and Profit Shifting (July 19, 2013). See also Vanessa Barford and Gerry Holt, "Google, Amazon, Starbucks: The Rise of 'Tax Shaming,'" BBC News Magazine, May 21, 2013.

¹⁰⁸A de minimis exception also applies to state aid, which would exclude smaller cases. See discussion in Luja, *supra* note 29, at section 5.06.

¹⁰⁹SAM communication, *supra* note 85, at para. 19.

¹¹⁰Commission notice 2009/C 136/04, code of best practice for the conduct of state aid control procedures, 2009 O.J. C 136/13, para. 48.

¹¹¹See 1998 notice, *supra* note 6, at para. 4 ("this notice also aims to ensure consistency and equality of treatment between Member States").

¹¹²Case C-300/04, *M.G. Eman and O.B. Sevinger v. College van burgemeester en wethouders van Den Haag*, 2006 E.C.R. I-8055, para. 57. See also council reg. 2015/1589, preamble para. 34 (commission should "address similar issues in a consistent manner across the internal market").

¹¹³Council reg. 2015/1589, art. 12 (1); preamble para. 23.

State Aid Special Report – Part 6: Arm’s Length on Appeal

by Ruth Mason



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In this final installment in a series of reports on state aid, Mason evaluates the European Commission’s decisions in the recent state aid cases involving income allocation. She focuses on whether the *sui generis* arm’s-length standard that the commission applied in those cases will be upheld on appeal.

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In a recent series of high-profile cases, the commission held that several EU member states granted illegal state aid through tax rulings that conferred selective advantages.¹ Although the commission supported its state aid conclusions on several alternative grounds, the most controversial was the idea that the Treaty on the Functioning of the European Union requires member states to adhere to a state-aid-specific notion of the arm’s-length standard for allocating income to multinationals. This report discusses the income allocation cases,² shows how the commission derived its *sui generis* arm’s-length standard, and evaluates whether the EU courts will uphold it.

The TFEU uses the following language to forbid EU member states from selectively subsidizing businesses:

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

¹ See, e.g., Commission Decision 2017/502 (Oct. 21, 2015) on state aid implemented by the Netherlands to Starbucks, 2017 O.J. (L 83) 38, para. 254 (*Starbucks* final); Commission Decision 2016/2326 (Oct. 21, 2015) on state aid Luxembourg granted to Fiat, 2016 O.J. (L 351) 1, para. 219 (*Fiat* final); and Commission Decision 2017/1283 (Aug. 30, 2016) on state aid implemented by Ireland to Apple, 2017 O.J. (L 187) 1, para. 224 (*Apple* final). The Belgian excess profits case is a “scheme” case, not individual aid. In a scheme case, the commission argues that an entire regime — here the excess profits ruling regime — constituted state aid. See Commission Decision 2015/9837 (Jan. 11, 2016) on the excess profit exemption state aid scheme implemented by Belgium, SA.37667 (*Excess Profits* final).

² This report therefore does not cover the McDonald’s case, which involved tax treaty interpretation issues. See Fadi Shaheen, “Tax Treaty Aspects of the McDonald’s State Aid Investigation,” *Tax Notes Int’l*, Apr. 24, 2017, p. 331.

between member states, be incompatible with the internal market.³

To anyone reading this far in my reports, the elements of illegal state aid are familiar.⁴ There must be (1) an advantage (2) granted by a member state (3) to an undertaking. The advantage must be granted (4) selectively, and it must (5) distort trade or competition in the internal market.⁵ A tax advantage otherwise satisfying the above elements still can be justified by the nature or general scheme of the tax system.⁶ Because the other elements are easily satisfied, tax cases turn on whether there was a selective advantage. EU law explicitly recognizes that the state aid concept evolves with the internal market.⁷

This is my sixth and final installment in a multi-part report on tax rulings as state aid. This installment focuses on whether the *sui generis* arm's-length standard that the commission applied to show selective advantage in the recent income allocation cases will be upheld on appeal.

I. The Troubled Reference Base Approach

There are two kinds of state aid: general and individual. Cases involving individual aid — in which only a particular undertaking receives aid — presumptively satisfy the selectivity requirement.⁸ The commission argued that the recent cases involved individual aid,⁹ but to cover its bases, the commission also argued that the

cases involved non-individual or general aid. The commission must establish selectivity in general aid cases.

The selectivity doctrine is developing rapidly in the tax area. A measure is selective when it “confers the benefit . . . exclusively on certain undertakings or certain sectors of activity.”¹⁰ There is considerable controversy over what that means, but a few things are clear: Selectivity is gauged by the practical effect of the contested measure,¹¹ and a measure that is available on the same terms to every similarly situated undertaking is not selective.¹²

In nontax cases, the commission determines whether a member state conferred state aid by asking whether the state held the enterprise at arm's length. States confer illegal aid when, to benefit specific enterprises, they take actions that independent investors would not have taken. Thus, a member state loan to, or investment in, a company constitutes illegal aid if independent investors would not have made the same loan or investment on the same terms.¹³

This counterfactual approach simply does not work in tax cases. Because only states impose taxes, there are no comparables that the commission can use to establish whether the state acted as a private market economy operator would have.¹⁴ To resolve this dilemma, the commission normally determines selectivity by following a three-step procedure. It (1) identifies a reference baseline consisting of generally applicable domestic tax law, then (2) shows that the state deviated from the baseline in a way that benefitted some enterprises while failing to benefit (3) other enterprises in a comparable

³ See Consolidated Version of the Treaty on the Functioning of the European Union, art. 107(1), 2010 O.J. (C 83) 47, art. 107(1) (Mar. 30, 2010).

⁴ Ruth Mason, “Tax Rulings as State Aid FAQ,” *Tax Notes*, Jan. 23, 2017, p. 451; Mason, “State Aid Special Report — Part 2: Legitimate Expectations,” *Tax Notes*, Jan. 30, 2017, p. 615; Mason, “Special Report on State Aid — Part 3: Apple,” *Tax Notes*, Feb. 6, 2017, p. 735; Mason, “Tax Rulings as State Aid — Part 4: Whose Arm's-Length Standard?” *Tax Notes*, May 15, 2017, p. 947; and Mason, “An American View of State Aid,” *Tax Notes*, Oct. 30, 2017, p. 645.

⁵ Joined Cases C 164/15 P and C 165/15 P, *Aer Lingus*, EU:C:2016:990, para. 28.

⁶ Joined Cases C-106/09 P and C-107/09 P, *Gibraltar*, EU:C:2011:732, para. 36. The aid must be proportional to the justification.

⁷ See Council Reg. 2015/1589 (July 13, 2015), laying down detailed rules for the application of TFEU art. 108 (codification) (2015 regulation); and TFEU art. 1(b)(v) (characterization of a measure as existing aid can change “due to the evolution of the internal market”).

⁸ Case C-15/14 P, *Commission v. MOL*, EU:C:2015:362, para. 60 (“The identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective.”).

⁹ *Starbucks* final, *supra* note 1, at para. 254; *Fiat* final, *supra* note 1, at para. 218; and *Apple* final, *supra* note 1, at para. 244. *Excess Profits* final involved a state aid “scheme,” not individual aid.

¹⁰ Joined Cases C 20/15 P and C 21/15 P, *World Duty Free Group*, EU:C:2016:981, para. 55 (citing Case C270/15 P, *Belgium v. Commission*, EU:C:2016:489, paras. 49 and 50).

¹¹ See, e.g., Joined Cases C-106/09 P and C-107/09 P, *Gibraltar*.

¹² Commission notice on the notion of state aid as referred to in TFEU art. 107(1), O.J. C 262/1, at para. 119 (July 19, 2016) (2016 notice). *But see Gibraltar*.

¹³ See, e.g., 2016 notice, *supra* note 12, at para. 98 (“To establish whether a transaction is in compliance with market conditions, that transaction can be assessed in the light of the terms under which comparable transactions carried out by comparable private operators have taken place in comparable situations.”). The commission also uses other techniques outside the tax context that cannot be replicated for tax. See, e.g., *id.*, para. 102 (calculation of the internal rate of return on the member state's investment in the enterprise).

¹⁴ See 2016 notice, *supra* note 12, at paras. 73-85.

factual and legal situation.¹⁵ The idea of a reference base does not appear in the state aid articles of the TFEU¹⁶ nor in EU state aid regulations, but the commission outlined it in published guidance, and the Court of Justice of the European Union accepts the approach.¹⁷

According to the commission, the reference system is “a consistent set of [tax] rules that generally apply — on the basis of objective criteria — to all undertakings falling within its scope as defined by its objective.”¹⁸ The commission clarifies that the reference system “is based on such elements as the tax base, the taxable persons, the taxable event, and the tax rates.”¹⁹ As examples of reference bases, the commission cites the corporate tax, the VAT, and “the general system of taxation of insurance.”²⁰

The choice of a reference base is probably the most controversial doctrinal aspect of the recent cases, and member states appealing the recovery orders have challenged the commission’s reference base judgments.²¹

To get a sense of the difficulty of establishing a tax reference base, consider whether a territorial tax regime constitutes state aid. Under a territorial tax regime, a state taxes resident companies on domestic income but exempts their foreign-source income. Under such a system, do companies with foreign-source income receive a selective advantage? To answer, we need a reference baseline. Three come immediately to mind.²²

First, the baseline could be taxation of all of a company’s income, regardless of source. If worldwide tax is the baseline, territoriality would confer selective advantages to taxpayers with foreign-source income but not to companies without foreign-source income. The state might

try to justify the exemption of foreign-source income by citing the need to avoid double taxation, but the commission might say credits are sufficient to achieve that goal.

Alternatively, if the commission regards territoriality, along with its exemption for foreign-source income, as the reference base, there would be no advantage, no aid, and no need for justification.²³

A third possible baseline might be single taxation of all of a resident’s worldwide income at the home country’s tax rate. In that case, exemption would confer advantages only when the source tax rate was lower than the residence rate.

Different baselines generate different conclusions on whether an advantage exists or whether that advantage is selective. The commission and EU courts provide little guidance on how to construct the reference base, and cases follow no clear pattern.²⁴ Advocate General Niilo Jääskinen recently noted commentators’ complaints that “neither the European Commission nor the Court of Justice has succeeded in determining precisely what is covered by the term ‘derogation from the norm’ or what constitutes the ‘norm’ or ‘a general system.’”²⁵

In her opinion in *Linz*, Advocate General Juliane Kokott likewise highlighted the problem of multiple potential baselines. She reported that the Austrian court that referred *Linz* to the CJEU offered three different potential baselines for evaluating an Austrian goodwill amortization rule for groups: the entire body of Austrian law on

¹⁵ *Id.* at para. 128.

¹⁶ See TFEU arts. 107-109.

¹⁷ 2016 notice, *supra* note 12, at para. 128.

¹⁸ *Id.* at para. 133.

¹⁹ *Id.* at para. 134.

²⁰ *Id.*

²¹ See *infra* discussion Section II.

²² Werner Haslehner provided an example in which the question was whether a double-tax relief provision constituted state aid. He proposed five different plausible reference bases and five plausible groups against which the taxpayer receiving the relief could be compared. Haslehner, “Double Taxation Relief, Transfer Pricing Adjustments, and State Aid Law,” in *State Aid Law and Business Taxation* 117-119, 139-141 (2016).

²³ That the commission selected territorial taxation as the reference base in a recent case strongly suggests that the commission regards territorial taxation as an acceptable part of a reference base (*i.e.*, territoriality is not aid per se). State Aid SA.34914 (2013/C) — (ex 2013/NN) — United Kingdom Gibraltar Corporate Tax Regime, C(2013) 6654 final, para. 32 (Oct. 16, 2013). *But see id.* at para. 40 (noting that Gibraltar’s territorial tax regime was justified to prevent double tax because Gibraltar had no tax treaties).

²⁴ My last report traced the interpretation of selectivity in the business tax context up to the current cases. Mason, “An American View of State Aid,” *supra* note 4.

²⁵ Joined Cases C-106/09 P and C-107/09 P, *Gibraltar* (opinion of Jääskinen) EU:C:2011:215, para. 184.

the taxation of profits, just corporate tax law, or the law concerning group taxation.²⁶ Kokott went on to make the point that the choice of the reference base therefore could not be a decisive element of the state aid analysis. I conclude the opposite — that selection of the reference base usually determines the outcome of the state aid inquiry.²⁷

The recent cases pose the following question: What is the reference base in a case involving the allocation of income from the cross-border activities of multinationals? In some of those cases, the commission uses as the reference base the state's own rules for allocating international income.²⁸ Other times it uses the state's rules for taxing domestic income of stand-alone companies,²⁹ and still other times it uses the state's rules for stand-alone companies combined with the commission's normative view on how states ought to allocate international income.³⁰

Likewise, establishing the reference base (and thereby measuring recovery) in rate cases is, as far as I can tell, arbitrary.³¹

²⁶Case C-66/14, *Finanzamt Linz v. Bundesfinanzgericht* (opinion of Kokott), EU:C:2015:242, para. 88. The CJEU ultimately disposed of *Linz* on other grounds, so it was not forced to choose among the proffered reference bases.

²⁷I made the analogous point in the fundamental freedoms context. See Mason, "Made in America for European Tax: The Internal Consistency Test," 49 *B.C. L. Rev.* 1277 (2008).

²⁸Joined Cases C-182/03 and C-217/03, *Forum 187 ASBL*, EU:C:2006:416.

²⁹See *infra* discussion Section IV.B. See also Richard Lyal, "Transfer Pricing Rules and State Aid," 38 *Ford. Int'l L. J.* 1017, 1040 (2015) (arguing that in transfer pricing cases, "the identification of the reference system seems straightforward. It is quite simply the taxation of independent companies. They are taxed on their revenue less costs, both sides of the equation being fixed by the market. For related companies the answer is no different: they are taxed on revenue less costs, [and the] surrogate for market prices is an arm's-length price which must be arrived at by a uniform and defensible method.").

³⁰See *infra* discussion Sections II through IV.

³¹In recent notified aid cases, the commission threw up its hands, declaring that it had no way to determine the reference base in a progressive tax rate case. See, e.g., Commission Decision 2016/1848 (July 4, 2016), on the measure implemented by Hungary on the 2014 amendment to the Hungarian food chain inspection fee, 2016 O.J. (L 282) 63. Eschewing a reference base is practical in notified aid cases in which the commission either red-lights or green-lights the proposed tax regime. But in *Aer Lingus*, a recent case involving unnotified aid, when the commission needed a reference base to calculate the recovery from the taxpayers, the commission picked the highest tax rate as the reference base, which maximized the violation and therefore the recovery. The CJEU confirmed that approach on appeal. See Joined Cases C 164/15 P and C 165/15 P, *Aer Lingus*, EU:C:2016:990 (discussed *infra* Section IV.D.2). In the United States, we have the same problem with whether progressive taxes should be characterized as tax expenditures.

Along with advocates general, other experts have acknowledged the difficulty of distinguishing the reference base from deviations from the reference base,³² and states' use of regulatory taxes exacerbates the problem. The reference base problem is familiar in tax expenditure analysis, in which there is no ready solution. In tax expenditure analysis, we usually rely on the notion that although we lack perfect agreement about what constitutes the baseline and what the deviations are, there is enough agreement that the concept retains analytical force.³³

But the stakes are higher in state aid analysis because the reference base also serves as the method for calculating the dollar amount of the recovery. Under EU rules, the commission orders the member state to collect (with interest) the additional tax the state would have collected had it applied the proper reference base to the taxpayer.³⁴ Thus, it is not enough to know that a tax provision conferred an advantage; courts must be able to measure the advantage against a baseline in order to calculate the recovery.³⁵

The uneasy consensus we have reached in the United States on the estimation of tax expenditures is absent from state aid analysis, in which among the provisions the commission has held to be selective are payroll and property taxes capped at a percentage of profits (because they

³²See Lyal, *supra* note 29, at 1030-1031 (noting that all regulatory taxes could be examined as state aid but warning that such an approach "could lead to extensive intervention of State aid control in the economic policy of member states" and that "it is not clear just to what extent the scope and purpose of the State aid provisions of the Treaty justify such intervention"). See also Axel Cordewener, "Asymmetrical Tax Burdens and EU State Aid Control," 2012/6 *EC Tax Rev.* 288 (considering baseline issues).

³³The federal budget describes in detail the (sometimes arbitrary) baseline choices made in estimating tax expenditures. See, e.g., Office of Management and Budget, "Fiscal Year 2015, Analytical Perspectives," at 127-165 (2014).

³⁴Joined Cases C 164/15 P and C 165/15 P, *Aer Lingus*, EU:C:2016:990, para. 100 ("Recovery of aid entails the restitution of the advantage procured by the aid for the beneficiary, not the restitution of the economic benefit that may have been conferred by the aid as a result of the exploitation of the advantage. There is therefore no need to examine whether and to what extent those [beneficiaries] actually utilised the economic advantage" by, for example, lowering prices.).

³⁵The EU conceives of recovery as disgorgement rather than as a penalty.

favor more profitable companies over less unprofitable companies),³⁶ taxes on property (which favor companies with less property over companies with more property), and taxes on payroll (which favor companies with fewer employees over companies with more employees), at least when the payroll and property taxes were not coupled with a general corporate net income tax.³⁷ And all those selectivity findings were in a single case: *Gibraltar*.³⁸ I will discuss *Gibraltar* later.³⁹

The reference base issue is central to determining the relative power of the commission and the member states. Fewer constraints on the commission's choice of reference base mean greater state aid enforcement powers in the commission and reduced tax powers in the states. Choices about the reference base should be made in light of the goals underlying the state aid prohibition. Unfortunately, with the exception of *World Duty Free*, discussed in my most recent report,⁴⁰ the commission and EU courts often miss opportunities to connect analysis in tax cases to the normative justifications for the state aid prohibition. Articulated values include promoting a level playing field for market competitors, ensuring market integration, ensuring single taxation, combatting tax evasion and avoidance, and enforcing the so-called benefits principle by allocating income to the source jurisdiction.⁴¹ Those values may conflict with each other, and they have differing implications for the scope of the state aid

prohibition. Lack of clear normative goalposts means that state aid decisions are often characterized by a disagreement between the commission and the member state over what constitutes the reference base, leaving commission decisions vulnerable to criticism that they are ad hoc and outcome-driven.

My most recent report suggested that the commission could improve legal certainty by abandoning the reference base approach in favor of a nondiscrimination approach like the one the CJEU uses to analyze cases under the fundamental freedoms.⁴² But the commission appears committed to the reference base approach in all but exceptional cases, and it used the reference base approach in the recent income allocation cases discussed here.

II. The Income Allocation Cases

This section focuses on the commission's selectivity analysis in its final rulings in the recent income allocation cases. It is primarily descriptive; those familiar with the cases should skip to Section III.

A. Starbucks Final

In *Starbucks* final, decided in October 2015, the commission concluded that the Netherlands granted rulings that attributed too little of Starbucks's profit to the Netherlands. The Netherlands had incorporated into domestic law the arm's-length standard and the 1995 OECD transfer pricing guidelines.⁴³ Most of the commission's decision focused on showing that because Starbucks did not apply the arm's-length standard properly in its ruling request, the Dutch Ministry of Finance should not have granted the ruling.

As a result of these flawed rulings, Dutch Starbucks, which among other functions roasted and packaged Starbucks beans, paid what the

³⁶ Commission Decision 2005/261 (Mar. 30, 2004), on Gibraltar corporation tax reform, 2005 O.J. (L 85) (*Gibraltar* final), at para. 133 ("The exemption of unprofitable companies from payroll tax and business property occupation tax through the operation of the 15 percent cap is selective.").

³⁷ *Id.* at para. 143 (holding payroll and property taxes selective, at least when they are not accompanied by a net corporate income tax — that is, "a general system of taxation of company profits"). The commission held payroll and property taxes to be selective because Gibraltar had many offshore companies that would tend to be exempt. Thus, the advantageous exemption was "not effectively open to all firms on an equal basis." *Id.*

³⁸ See Joined Cases C-106/09 P and C-107/09 P, *Gibraltar*, EU:C:2011:732 (rejecting the commission's analysis on profits but accepting it on property and payroll taxes).

³⁹ See *infra* Section IV.D.1.

⁴⁰ Mason, "An American View," *supra* note 4, at 651-652 (describing how in *World Duty Free* the commission and the CJEU connected selectivity analysis to the state aid goal of preventing favoritism of cross-border over domestic investment).

⁴¹ See Mason, "Part 4," *supra* note 4.

⁴² As part of a nondiscrimination approach, the commission could use a tiers of scrutiny model like the one the U.S. federal courts use in equal protection clause analysis. Under that approach, the commission would compare the treatment of the suspect class with treatment of the non-suspect class. My review of the case law reveals that the CJEU would consider the following to be suspect classifications: sector, region, size, type, and engagement in cross-border economic activity. Mason, "An American View," *supra* note 4.

⁴³ *Starbucks* final, *supra* note 1, at para. 87.

commission regarded as too much to a Swiss affiliate for raw beans, and it paid royalties that the commission regarded as too high to a British affiliate for various licenses, trademarks, and recipes. Those payments reduced the company's taxable income in the Netherlands, resulting in too little tax there.

The commission followed the traditional three-step process for establishing a selective advantage: (1) identify the reference base, (2) identify the deviation, and (3) show that the deviation benefits some companies but not comparable others. The last element essentially requires the commission to show discrimination.⁴⁴

In determining the proper reference base for calculating the income of multinationals, the commission looked to the Netherlands's tax treatment of stand-alone domestic companies. According to the commission, taxable income for Dutch stand-alone companies "coincides with accounting profit (subject to certain adjustments)."⁴⁵ Along with Dutch tax rules for stand-alone Dutch companies, the commission said that the reference base also consisted of the tax rules for "group companies, which resort to transfer prices to allocate profits."⁴⁶

The commission specifically rejected the notion that the reference base included Dutch domestic law that set forth the arm's-length method and the decree under Dutch law that incorporated the 1995 OECD transfer pricing guidelines.⁴⁷ The commission also was unwilling to compare the Dutch treatment of Starbucks only with Dutch treatment of other multinationals.⁴⁸ Instead, the commission reasoned that the purpose of the Dutch arm's-length method and the OECD guidelines was "to align the tax treatment of related companies with the tax treatment of unrelated companies."⁴⁹ Thus, the reference base had to include stand-alone domestic companies. For good measure, the commission added that if the Netherlands had

special rules for group companies that did not apply to domestic companies (presumably including special allocation rules), that itself might be selective.⁵⁰

The commission went on to conclude that the Netherlands conferred a selective advantage because the ruling the Netherlands approved for Starbucks deviated from the arm's-length standard.⁵¹ But instead of using the Netherlands's own conception of arm's length (with its contemporaneous decree pointing to then-applicable 1995 OECD transfer pricing guidelines), the commission asserted that the state aid rules impose a state-aid-specific arm's-length income allocation requirement on the member states:

The arm's length principle therefore necessarily forms part of the Commission's assessment under Article 107(1) of the Treaty of tax measures granted to group companies independently of whether a member state has incorporated this principle into its national legal system.⁵²

The commission used that standard, rather than Dutch law incorporating the 1995 OECD transfer pricing guidelines, to prove a deviating advantage. To give content to its own arm's-length standard, the commission relied heavily on both the 1995 and the 2010 OECD transfer pricing guidelines, the latter of which postdated the *Starbucks* final ruling.⁵³ The commission concluded that the Dutch ruling for Starbucks deviated from this OECD-inflected, but ostensibly independent, arm's-length standard.⁵⁴

⁵⁰ *Id.* at para. 250.

⁵¹ Among the problems that the commission identified in the Dutch rulings for Starbucks were that the price for green beans lacked transfer pricing documentation, that comparable uncontrolled prices were available that Starbucks and the Ministry of Finance did not use, and that the Dutch entity was incorrectly identified at the less complex (tested) party in the transactional net margin method (TNMM) analysis and therefore erroneously allocated only a routine profit. See *Starbucks* final, *supra* note 1, at paras. 360-361, 377, 399, and 407.

⁵² *Id.* at para. 264.

⁵³ *Id.* at paras. 255-408 (repeatedly using the 2010 guidelines). The Netherlands granted the contested ruling in 2008. *Id.* at para. 40.

⁵⁴ *Id.* at para. 265.

⁴⁴ See generally Mason, "An American View," *supra* note 4. See also Cordewener, *supra* note 32.

⁴⁵ *Starbucks* final, *supra* note 1, at para. 244.

⁴⁶ *Id.*

⁴⁷ *Id.* at para. 246.

⁴⁸ *Id.* at para. 249.

⁴⁹ *Id.*

As an alternative line of reasoning, the commission also concluded that the Netherlands failed to follow its own transfer pricing rules.⁵⁵

As the last step in establishing selectivity, the commission must show that the member state discriminated in granting the advantage — that some undertakings received the benefit while comparable others did not.

The commission compared groups and stand-alone companies and found that they were in a “similar factual and legal situation.”⁵⁶ Whereas determining the income of stand-alone companies was “straightforward,”⁵⁷ income of groups required the “use of proxies,”⁵⁸ but the commission concluded that the Dutch tax system’s goal for both was the same — namely, to “tax profits of all companies subject to tax in the Netherlands.”⁵⁹ Because the tax goal for stand-alone companies and groups was the same, stand-alone companies and groups were comparable, and they had to be treated the same.

According to the commission, treating groups and stand-alone companies the same demanded application of the commission’s own state aid arm’s-length principle to group companies. This was because, in the commission’s view, that principle approximates a market-based outcome, which the commission regarded as the relevant standard for whether a state conferred an advantage in calculating a group member’s income.⁶⁰ Deviations from the commission’s state aid arm’s-length standard were discriminatory and therefore selective.

Although the commission claimed that the state aid rules entitled it to evaluate the *Starbucks* final ruling according to its own, independent arm’s-length standard, in actually conducting its analysis of whether the Netherlands violated that standard, the commission relied heavily on contemporaneous and modern OECD guidance on the arm’s-length

method.⁶¹ Experts can differ about whether the commission applied the OECD guidance correctly.

Among other arguments on appeal, the Netherlands argues that the commission used the wrong reference base and erroneously judged the *Starbucks* ruling by whether it deviated from an EU arm’s-length standard, which the Netherlands argues does not exist. It also argues that the commission erroneously rejected the Netherlands’s application of the transactional net margin method (TNMM) in favor of the commission’s own application of that method even though, according to the Netherlands, the commission never showed that its own method was superior to the one the Netherlands had used.⁶² *Starbucks* makes similar arguments.⁶³

B. Fiat Chrysler Final

Fiat final involved a ruling granted by Luxembourg.⁶⁴ Fiat had a financing subsidiary in Luxembourg called FFT, which had branches in the United Kingdom and Spain. Luxembourg approved a ruling for FFT that, in the commission’s view, “seemed to agree to a fixed base of tax . . . that . . . remain[ed] stable even if FFT, for example, significantly increased its activities.”⁶⁵ In the commission’s view, the ruling allowed FFT to report too little income to Luxembourg.

As with *Starbucks* final, the commission decided that the reference base was “the general Luxembourg corporate tax system,” “which has as its objective the taxation of profits of all companies subject to tax in Luxembourg.”⁶⁶ The Luxembourg tax base, as the commission saw it, defined taxable income as “profits realized minus tax-deductible expenses and losses.”⁶⁷ For stand-

⁵⁵ *Id.* at paras. 409-412 (citing the OECD guidelines that the Netherlands had transposed to domestic law).

⁵⁶ *Id.* at para. 236.

⁵⁷ *Id.* at para. 235.

⁵⁸ *Id.*

⁵⁹ *Id.* at para. 236.

⁶⁰ *Id.* at para. 334.

⁶¹ *Id.* at paras. 255-408.

⁶² Case T-760/15, Action for Annulment (Dec. 23, 2015), *Netherlands v. Commission*, 2016 O.J. (C 59) 50.

⁶³ Case T-636/16, Action for Annulment (Sept. 5, 2016), *Starbucks and Starbucks Mfg. Emea v. Commission*, 2016 O.J. (C 462) 25.

⁶⁴ *Fiat* final, *supra* note 1. The commission formally began its investigation of FFT in June 2014. At that time, the commission suspected, but Luxembourg had not yet confirmed, that FFT was part of the Fiat group. *Id.* at para. 13-6. Fiat and Chrysler merged in August 2014.

⁶⁵ *Id.* at para. 131.

⁶⁶ *Id.* at paras. 193-194.

⁶⁷ *Id.* at para. 194.

alone companies, that calculation was “straightforward,” but for group companies it required the “use of proxies.”⁶⁸

Even though it acknowledged that income could not be calculated in the same way for stand-alone companies and multinationals, the commission concluded, as it had in *Starbucks* final, that this fact had “no relevance for determining the reference system,” and further, that “both types of companies should be considered to be in a similar factual and legal situation.”⁶⁹ The commission in *Fiat* final thereby handled the reference base question and the comparability question together. As with *Starbucks* final, the tax base for stand-alone companies in Luxembourg was “accounting profit (subject to certain adjustments based on tax law),” while for group companies Luxembourg resorted “to transfer prices to allocate profits.”⁷⁰

As in *Starbucks* final, in *Fiat* final the commission rejected the notion that the reference base should consist only of Belgium’s treatment of other multinational groups; it also rejected Fiat’s argument that the reference base should consist only of group financing companies.⁷¹

Luxembourg law incorporated the arm’s-length method and the OECD transfer pricing guidelines,⁷² but Luxembourg argued that the reference base should also include “national law and practice,”⁷³ including administrative explanations for how to determine arm’s-length remuneration for intragroup financing.⁷⁴ In contrast, citing *Forum 187*, the commission concluded:

The arm’s length principle . . . necessarily forms part of the European Commission’s assessment under Article 107(1) of the TFEU of tax measures granted to group

companies, *independently* of whether a member state has incorporated this principle into its national legal system. It is used to establish . . . that that company is not treated favourably under the general corporate income tax system as compared to non-integrated companies whose taxable profit is determined by the market.⁷⁵

Thus, as in *Starbucks* final, in *Fiat* final the commission claimed authority to evaluate Luxembourg’s rulings against its own independent arm’s-length standard rather than Luxembourg’s allocation rules and administrative guidance.

In answer to Luxembourg’s objection that the commission “replaces the national tax authorities in the interpretation of Luxembourg law,” the commission responded that it had not measured the derogation as compared to Luxembourg law, but rather as compared to the independent arm’s-length principle that applies in all state aid cases.⁷⁶ As with *Starbucks* final, after asserting its prerogative to apply its own arm’s-length standard, the commission actually seemed to judge Luxembourg’s *Fiat* final ruling by OECD standards.⁷⁷

Again, as an alternative line of reasoning, the commission also concluded that Luxembourg violated its own domestic arm’s-length standard in the *Fiat* ruling.⁷⁸

On appeal, Luxembourg argues that the commission failed to prove any of: advantage, selectivity, or a restriction of competition.⁷⁹ For its

⁷⁵ *Id.* at para. 228 (emphasis added).

⁷⁶ The commission explained that it was not examining whether the contested ruling complied with the arm’s-length principle as laid down in Luxembourg’s domestic arm’s-length legislation or Luxembourg guidance on arm’s length for intragroup financing, “but whether the Luxembourg tax administration conferred a selective advantage on FFT for the purposes of Article 107(1) of the TFEU by issuing a tax ruling that endorses a profit allocation that departs from the amount of profit . . . if the same transactions had been executed by independent companies negotiating under comparable circumstances at arm’s length.” *Id.* at para. 229.

⁷⁷ *Id.* at paras. 219-311 (applying the 2010 transfer pricing guidelines).

⁷⁸ *Id.* at paras. 315-317. As a second alternative line of reasoning, the commission concluded that Luxembourg lacked a consistent method for allocating this type of income, which itself conferred selective advantages through inconsistent application. *Id.* at paras. 325 and 336.

⁷⁹ Case T-755/15, Action for Annulment (Dec. 30, 2015), *Luxembourg v. Commission*, 2016 O.J. (C 59) 48.

⁶⁸ *Id.* at para. 197.

⁶⁹ *Id.* at paras. 198-199.

⁷⁰ *Id.* at para. 209.

⁷¹ *Id.* at para. 210. The commission compelled Luxembourg to submit all its other rulings for financing companies, which amounted to 21 rulings. Fiat argued that establishing a derogation required the commission to show that Luxembourg treated Fiat better than it treated the other 20 finance companies. *Id.* at para. 210.

⁷² *Id.* at para. 77.

⁷³ *Id.* at para. 148.

⁷⁴ *Id.* at para. 79.

own part, Fiat Chrysler argues that “the European Commission’s novel formulation of the arm’s length principle introduces complete uncertainty and confusion as to when an advance pricing agreement, and indeed any transfer pricing analysis, might breach EU state aid rules.”⁸⁰

C. Belgian Excess Profits Final

Belgian Excess Profits final involved Belgium’s regime that exempted so-called excess profits, defined as those deriving from economies of scale, synergies, and the like.⁸¹ Belgium limited the exclusion of excess profits in several ways: Exclusion required an administrative ruling from Belgium; only multinational (not domestic) groups could apply for excess profits rulings; and the commission argued (although Belgium disputed) that Belgium conditioned rulings on the requirement that the requesting taxpayer increase its activities in Belgium.⁸² The commission ultimately concluded that the ruling regime conferred state aid.

According to the commission’s description:

Excess profit is determined by estimating the hypothetical average profit that a stand-alone company carrying out comparable activities could be expected to make in comparable circumstances and subtracting that amount from the profit actually recorded by the Belgian group entity in question.⁸³

Belgium identified excess profits through a multi-step process that required the taxpayer to get a ruling.⁸⁴ In step one, Belgium assumed the Belgian company seeking the ruling was the “central entrepreneur,” the untested party under the TNMM. As a result, under the TNNM, non-Belgian affiliates would be assigned only a (small) normal return. That left the (large) residual with the Belgian central entrepreneur.

Then, in the second step, Belgium reversed the assumption in the first step. Now Belgium assumed the Belgian company was the tested party that performed only routine functions and therefore should earn only a routine return. That meant that the residual was allocated abroad to the foreign affiliates.

The third step essentially excluded from tax the difference in the results between the first two steps.⁸⁵ In this way, Belgium claimed that it identified, quantified, and excluded excess profits, which were exempt as a matter of tax policy.

The exclusion required a downward adjustment by Belgium. That adjustment was not conditioned on a corresponding upward adjustment by any other state,⁸⁶ and Belgium did not inform any other state of its own downward adjustment. The Belgian Finance Ministry explained that it did not inform any other country of the downward adjustment because “it is not for Belgium to specify to which country excess profit ought to be attributed and . . . it is therefore not possible to determine with which country the information on a Belgian downward adjustment should be exchanged.”⁸⁷ Belgium claimed that “the rationale for the Excess Profit exemption is to ensure that a Belgian group entity is only taxed on its arm’s length profit by exempting . . . profit [that] corresponds to synergies, economies of scale or other benefits drawn from its participation in a multinational group and which would not exist for a comparable stand-alone company.”⁸⁸

The first step in determining whether Belgium granted state aid was for the commission to identify the reference base. Although Belgium argued that the excess profits regime should be

⁸⁰ Case T-759/15, Action for Annulment (Dec. 29, 2015), *Fiat Chrysler Finance Europe v. Commission*, 2016 O.J. (C59) 49.

⁸¹ *Excess Profits* final, *supra* note 1, at para. 13.

⁸² *Id.* at paras. 20-21 (noting that rulings were available only for “new situations,” which the commission characterized as “conditioned upon relocation or increase of activities in Belgium and . . . proportional to the importance of the new activities and profit created in Belgium”).

⁸³ *Id.* at para. 13.

⁸⁴ *Id.* at para. 15.

⁸⁵ This is a simplified explanation. Details are available in the commission’s decision. *Excess Profits* final, *supra* note 1, at para. 18.

⁸⁶ *Id.* at para. 117. See *id.* at para. 174 (the commission identified this feature as “an important element distinguishing rulings granting the Excess Profit exemption from other transfer pricing rulings authorising a downward transfer pricing adjustment”). The commission impliedly approves ordinary correlative or compensating adjustments as contemplated in article 9 of the OECD model treaty. *Id.* at paras. 174-181.

⁸⁷ *Id.* at para. 41.

⁸⁸ *Id.* at para. 14.

regarded as part of the baseline,⁸⁹ the commission rejected that argument and concluded that the:

objective of the Belgian corporate income tax system is to tax all corporate taxpayers on their actual profits, whether they are a stand-alone or group company, whether they form part of a domestic or multinational group, whether they form part of a large or small multinational group, and whether they have recently established operations in Belgium or whether they have operated in Belgium for many years. In other words, all those taxpayers are in a comparable legal and factual situation.⁹⁰

Having identified taxing “actual profits” as the objective of the Belgian tax regime, the commission also concluded that recorded profits are actual profits.⁹¹ A member state may adjust recorded profits for tax purposes, but permissible adjustments must be “of a general nature and . . . not selective.”⁹²

The commission’s analysis in *Belgian Excess Profits* final closely resembled that in *Starbucks* final and *Fiat* final.⁹³ It concluded that Belgium violated the independent state aid arm’s-length principle.⁹⁴ To prove its case, the commission repeatedly cited the OECD transfer pricing guidelines. The commission’s main conclusion was that Belgium applied the TNMM incorrectly,

an unobjectionable conclusion in light of Belgium’s nonstandard three-step income calculation process.⁹⁵ And because the commission had already concluded that the exclusion of excess profits was not part of the reference base, the rulings represented a deviating advantage.⁹⁶

The commission submitted several reasons why the deviation discriminated. For example, even though all groups had profits attributable to synergies and economies of scale, only multinational groups could exclude them, while domestic groups had to include them.⁹⁷ The commission also noted that only large multinationals received exemption rulings. Belgium responded that the regime was open to all, but the commission countered that the costs involved in obtaining an excess profits ruling dissuaded smaller companies.⁹⁸

The commission also concluded that Belgium granted excess profits rulings only for companies that increased their activities in Belgium. Thus, according to the commission, Belgium treated some multinationals better than others — it subsidized only companies expanding in Belgium.⁹⁹

On appeal, Belgium complains that the commission invaded Belgian competence by “using the state aid rules to unilaterally define the tax jurisdiction of the Belgian State.”¹⁰⁰ It also

⁸⁹ *Id.* at para. 123.

⁹⁰ *Id.* at para. 126.

⁹¹ *Id.*

⁹² *Id.* The commission also noted that taxable profit is the “difference between income and costs determined in a competitive market.” *Id.* at para. 127.

⁹³ Belgium’s response to the commission’s argument that the baseline was the tax of stand-alone companies was to argue that excluding the residual got multinationals closer to (not further from) the tax of stand-alone companies, because stand-alone companies do not earn excess profits. *Id.* at para. 17.

⁹⁴ *Id.* at paras. 134 and 145 (“The Commission considers the Excess Profit exemption to constitute a misapplication of and thus a deviation from the arm’s length principle, which forms a part of that [reference] system.”).

⁹⁵ The commission observed that the OECD guidelines do not provide for the serial application of the TNMM with the same entity regarded as (1) the untested party in the first application (and therefore allocated the excess profit) and (2) the tested party in the second application (and therefore allocated only a routine profit). *Excess Profit* final, *supra* note 1, at paras. 161-162. Nor do the guidelines provide a method for identifying and excluding the excess profit by subtracting the results of the serial application of TNMM. *Id.* at paras. 159 and 164. The commission also faulted Belgium for not requiring taxpayers to substantiate that the excess profit identified through serial application of TNMM was the result of synergies, economies of scale, and the like. *Id.* at para. 168.

⁹⁶ *Id.* at paras. 123-124, 131.

⁹⁷ *Id.* at para. 138.

⁹⁸ *Id.* at para. 140 (“Belgium was unable to provide a single example where the Excess Profit exemption was requested by and granted to a Belgian group entity that is part of a small multinational group.”).

⁹⁹ *Id.* at para. 139. Belgium disputed this point, arguing that the excess profit regime was open to all multinationals. *Id.* at para. 88.

¹⁰⁰ Case T-131-16, Action for Annulment (Mar. 22, 2016), *Belgium v. Commission*, 2016 O.J. (C191) 36.

argues that the commission failed to prove advantage, selectivity, or the use of state resources.¹⁰¹ At least 29 of the companies affected by the investigation have filed actions for annulment of the commission's decision.

D. Apple Final

An earlier installment of this series of reports provided in-depth analysis of *Apple* final.¹⁰² Here, I review the basics. The case involves a dispute about the amount of profit attributed to the Irish permanent establishments of two Irish-incorporated subsidiaries of Apple Inc., the U.S. ultimate parent. The subsidiaries were tax resident nowhere because of a mismatch between Irish and U.S. tax residence rules, which has since been resolved.¹⁰³ Using various strategies, Apple had shifted a large portion of its global income to the nowhere-resident subsidiaries, and it paid almost no current tax to any country on those profits.

The commission concluded that nearly all the income of the subsidiaries should have been allocated to the Irish PE of each nowhere-resident subsidiary and that Ireland's approval of rulings allowing Apple to allocate less income to the Irish branches therefore constituted state aid.

The commission followed the three-step reference base approach in *Apple* final.¹⁰⁴ The reference base was disputed. Ireland insisted that the reference base was Irish branch-profit allocation rules¹⁰⁵ that required inclusion of the "chargeable profits" attributable to the activities performed by the Irish branches.¹⁰⁶ But the

commission responded that although those allocation rules formed *a part* of the reference base that included the rest of the Irish corporate tax rules, the branch allocation rules did not constitute a "separate reference system onto itself."¹⁰⁷ Further, the commission noted (and Ireland acknowledged) that domestic law did "not provide guidance on how to determine the chargeable profit of an Irish branch."¹⁰⁸ Specifically, it did not adopt arm's length.

As in the prior cases, the commission asserted that the reference base was "the ordinary rules of taxation of corporate profit under the Irish corporate tax system, which have as their intrinsic objective the taxation of profit of all companies subject to tax in Ireland."¹⁰⁹ The commission specifically rejected the notion that the reference base consisted solely of Irish rules for taxing branches of nonresident companies.¹¹⁰ Although the commission acknowledged that the profits of integrated and non-integrated companies had to be determined differently because the profits of integrated companies "cannot be observed in a reliable way from the statutory accounts" and instead require "the use of estimates," what mattered to the commission was that the "ultimate goal" of the Irish tax system was to tax "integrated companies . . . on an equal footing to non-integrated companies."¹¹¹

As in the previous income allocation cases, the commission applied its own allocation rules — the state aid arm's-length standard — to determine what Ireland should have taxed.¹¹² In the commission's view, "transactions within an integrated company should be conducted as if they were carried out between nonintegrated companies on the market."¹¹³ As in *Starbucks* final and *Fiat* final, the commission asserted that this independent arm's-length standard originated in the state aid rules, not from the member state's

¹⁰¹ *Id.*

¹⁰² Mason, "Part 3," *supra* note 4.

¹⁰³ At the time the facts of the case arose, Irish law provided that only companies managed and controlled in Ireland were tax resident there. The United States has a place of incorporation rule for tax residence. The mismatch between the two states' rules meant that companies incorporated in Ireland but managed and controlled in the United States were tax resident nowhere. Ireland has since amended its rule to provide that companies incorporated in Ireland but not tax resident elsewhere under another country's rules will be tax resident in Ireland, even if not managed and controlled in Ireland.

¹⁰⁴ *Apple* final, *supra* note 1, at para. 224.

¹⁰⁵ *Id.* at para. 152 (citing section 25 of the Irish Taxes Consolidation Act of 1997 (TCA 1997)).

¹⁰⁶ *Apple* final, *supra* note 1, at para. 73 (citing domestic law as defining "chargeable profits" as "any trading income arising directly or indirectly through or from the branch or agency, and any income from property or rights used by, or held by or for, the branch or agency, [not including] distributions received from [resident] companies."). *Id.*

¹⁰⁷ *Id.* at para. 242.

¹⁰⁸ *Id.* at para. 248.

¹⁰⁹ *Id.* at para. 228 (citing Joined Cases C-78/08 to C-80/08, *Paint Graphos and Others*, EU:C:2011:550, para. 50).

¹¹⁰ *Id.* at para. 245 (referring to Irish law section 25 TCA 97).

¹¹¹ *Id.* at para. 230.

¹¹² *Id.* at paras. 249-257.

¹¹³ *Id.* at para. 254.

adoption of the arm's-length principle in domestic law.¹¹⁴

Again as in the prior cases, after asserting its prerogative to apply an independent arm's-length standard as a matter of state aid law, the commission went on to use OECD guidance to flesh out the independent standard.¹¹⁵ But the commission was careful to note that it applied OECD guidance not because Ireland incorporated it into domestic law or tax treaties but rather to elucidate the independent arm's-length principle that applied as a matter of state aid law. The commission stated:

The OECD framework is non-binding, [and] the European Commission considers that framework to provide useful guidance to tax administrations and multinational enterprises on how to ensure that transfer pricing and profit allocation arrangements produce outcomes in line with market conditions.¹¹⁶

According to the commission, member state deviation from OECD guidance in a ruling therefore “provides an additional indication that [the member state’s] method does not result in a reliable approximation of a market-based outcome in line with the arm’s length principle,” whereas a ruling consistent with the OECD framework “is unlikely to confer a selective advantage upon its recipient.”¹¹⁷ Pointedly, the commission emphasized again that the state aid arm's-length allocation standard applies “independently of whether the member state in question has incorporated the arm’s length principle in its national legal system.”¹¹⁸

Using modern OECD guidance, the commission then established that Ireland’s rulings for Apple did not meet the arm's-length standard because, among other reasons, (1) Ireland accepted Apple’s “unsubstantiated assumption” that intellectual property licenses held by the subsidiaries were properly attributed

to their head offices rather than their Irish branches,¹¹⁹ and (2) Ireland accepted Apple’s application of the TNMM, which was erroneous because it identified the wrong complex party, the wrong profit indicator, and too low a profit margin.¹²⁰ The commission emphasized other defects with the rulings, including the lack of a contemporaneous profit allocation report, the rulings’ long durations, and their lack of modification in light of substantial changes.¹²¹

The commission’s bottom line on Apple was that as between the Irish PEs and the nowhere-resident head offices, the Irish PEs had substance, while the head offices “existed only on paper.”¹²² As a result, Ireland should have insisted that the profit of the subsidiaries be allocated to the Irish branches, not the head offices.¹²³

The simplest way to understand Ireland’s response was that the vast booked income of the nowhere subsidiaries substantively wasn’t Irish, so that not only was Ireland not obliged to tax it, but there was no authority in Irish law for Ireland to tax it.¹²⁴ Ireland’s sole obligation, in its view, was to determine the profits of the Irish branches, for which purpose it could limit its analysis to the activities of Irish branches themselves. Ireland believed it was not obligated to allocate the income of the nowhere-resident subsidiaries to the more substantive of the two parts of the enterprise — the head offices versus the branches.¹²⁵

The commission concluded that Ireland’s failure to allocate income to the Irish branches according to the state aid arm's-length standard represented a selective advantage when “compared to non-integrated companies whose taxable profit reflects prices determined on the

¹¹⁴ *Id.* at para. 255.

¹¹⁵ *Id.* at paras. 244-368.

¹¹⁶ *Id.* at para. 255.

¹¹⁷ *Id.*

¹¹⁸ *Id.* at para. 257.

¹¹⁹ *Id.* at paras. 321-322.

¹²⁰ For more detail, see generally Mason, “Part 3,” *supra* note 4.

¹²¹ *Apple* final, *supra* note 1, at paras. 333-375.

¹²² *Id.* at para. 281.

¹²³ See, e.g., *id.* at paras. 276-307.

¹²⁴ See generally Mason, “Part 3,” *supra* note 4.

¹²⁵ *Id.*

market negotiated at arm's length."¹²⁶ For good measure, the commission also concluded that the Apple rulings derogated from Ireland's own income allocation rule, either because the de facto Irish rule was the arm's-length standard (despite Ireland's assertions to the contrary)¹²⁷ or because Ireland had no consistent set of profit allocation rules and instead just granted discretionary or negotiated rulings, which itself constitutes state aid.¹²⁸

On appeal, Ireland argues that even if what the commission refers to as the arm's-length principle were "legally relevant (which Ireland does not accept) the European Commission has failed to apply it consistently or to examine the overall situation of the Apple group."¹²⁹ Ireland also complains about the commission's retrospective application of modern OECD guidance, arguing that the commission "infringed the principles of legal certainty and legitimate expectations by invoking alleged rules of EU law never previously identified [and] OECD documents from 2010, but (even if they were binding) these could not have been foreseen in 1991 or 2007."¹³⁰ Ireland granted the contested rulings in 1991 and 2007.¹³¹ Ireland also argues that the commission failed to prove essential elements of its state aid cases, including advantage and selectivity.¹³² Apple made the same claims in its appeal.¹³³

E. Pending

Several other cases await final commission decision, including *GDF Suez*.¹³⁴ Additionally, although it has not released a public version of its final decision, the commission has already announced that Luxembourg will be required to recover about \$180 million from Amazon.¹³⁵

III. Advantages of *Sui Generis* ALS

Rather than viewing the arm's-length income allocation standard as constituting part of the reference base because the accused member states incorporated it into their domestic law, the commission concluded in these cases that arm's-length allocation was an independent requirement mandated by state aid law.¹³⁶ Moreover, rather than recognizing that each country applies its own brand of arm's-length, each taking what it finds helpful from the OECD and supplementing with its own domestic rules, the commission conceived its own arm's-length allocation rules for use in state aid allocation cases. While the commission used OECD guidance to flesh out its own conception of arm's length, it also claimed that it was not bound by OECD guidance.¹³⁷ In this way, the commission conceived a reference base that it could use in every case, regardless of domestic law. The development of this *sui generis* arm's-length allocation standard serves at least four goals for the commission.

First, it simplifies enforcement by providing a single standard that the commission can apply in every income allocation case, regardless of domestic law. It therefore avoids the considerable difficulty of identifying the reference base.

¹²⁶ *Apple* final, *supra* note 1, at para. 321.

¹²⁷ *Id.* at paras. 369-378.

¹²⁸ At least when it results in tax savings compared with the state aid arm's-length standard. *Id.* at paras. 379-403.

¹²⁹ Case T-778/16, Action for Annulment (Nov. 9, 2016), *Ireland v. Commission*, 2017 O.J. (C 38) 35.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ Case T-892/16, Action for Annulment (Dec. 19, 2016), *Apple Sales Int'l & Apple Operations Europe v. Commission*, 2017 O.J. (C 53) 37.

¹³⁴ Commission Decision (Sept. 19, 2016) initiating the formal investigation in SA.44888 (possible state aid in favor of GDF Suez), 2017 O.J. (C 36) 13. Experience has shown that the commission's approach can change significantly between its opening and final decisions.

¹³⁵ The commission's press release about its Amazon decision suggests that its analysis in that case was similar to that in the cases described here. See European Commission release, "State Aid: European Commission Finds Luxembourg Gave Illegal Tax Benefits to Amazon Worth Around €250 Million," IP/17/3701 (Oct. 4, 2017). See also Commission Decision (Oct. 7, 2014), initiating the formal investigation in SA.38944 (alleged aid to Amazon through a tax ruling), 2015 O.J. (C44) 02.

¹³⁶ *Starbucks* final, *supra* note 1, at paras. 264-265; *Fiat* final, *supra* note 1, at para. 229; *Excess Profits* final, *supra* note 1, at para. 150; *Apple* final, *supra* note 1, at paras. 255-257.

¹³⁷ See 2016 notice, *supra* note 12, at para. 173.

Second, it allows the commission to defeat arguments like Belgium's that as measured by its own state-specific reference base, the member state did not confer advantages. Belgium argued that the exclusion of excess profits did not constitute an advantage because those excess profits simply were not part of the Belgian tax base. The commission's response was that because the exclusion of excess profits violates the state aid arm's-length standard, it constitutes state aid. Belgium's policy preferences on the taxability of excess profits are simply irrelevant under the *sui generis* standard.¹³⁸

Similarly, Ireland insisted that the arm's-length method was not part of its domestic reference base for allocating income to branches of nonresident companies, so Ireland argued that it could not be faulted for failing to apply that standard to Apple's Irish branches. The commission responded with three alternative arguments. Ireland (1) actually used arm's length, despite its protests to the contrary, and varied from it for Apple; (2) had no standard whatsoever — it just made one-off deals with taxpayers, which itself constitutes state aid; or (3) it doesn't matter what standard Ireland used because all states must use the *sui generis* arm's-length standard, and failure to do so is state aid. Only the third alternative uses the universal state aid arm's-length standard. The implication is that no matter how rigorous a state's allocation rules (and neither Belgium nor Ireland seemed to exhibit much rigor in these cases), if the rule is anything other than the state-aid-specific arm's-length standard, the state grants illegal aid to companies that benefit from the deviating standard.

In this way, the commission abandoned its traditional domestic-law-reference-base approach in favor of a universal reference base approach, at least for allocation cases.

Third, the universal arm's-length allocation rule also defeats arguments that any tax savings experienced by select taxpayers arose from variation among national tax bases for which no particular state can be held responsible. If all

states must apply the same allocation rule (at least theoretically), no income should be lost to mismatches, at least within the EU.¹³⁹

Fourth, locating the arm's-length allocation requirement in the state aid rules (rather than as part of the domestic law reference base) allows the commission to mold the arm's-length allocation standard to suit its needs in the selectivity analysis — picking and choosing among contemporaneous, modern, and potentially even obsolete guidance from the OECD.

For example, the commission used a mix of contemporaneous and modern OECD standards to show that the Dutch ruling for Starbucks approved transfer prices that were not at arm's length.¹⁴⁰ Likewise, in *Apple* the commission heavily relied on the 2010 OECD PE profits attribution report,¹⁴¹ even though Ireland granted the latter of the two contested rulings in 2007.¹⁴² Not only had Ireland not endorsed the 2010 report for attributing profits to Irish branches, but the home offices of the relevant Irish branches did not reside in a state with which Ireland had a tax treaty (because they resided nowhere).¹⁴³ Thus, Ireland complained that the commission used OECD guidance that was intended to clarify the

¹³⁹ In an earlier case, the commission decided that a mismatch was not state aid. The case involved the Dutch *Groepsrentebox* regime, under which related-party debt was both deducted by the payer and included by the recipient at a lower-than-normal tax rate. The Netherlands's goal in enacting the regime was to reduce distortions by taxing intragroup debt more like equity. When a Dutch member of a corporate group received interest from a group member outside the Netherlands, however, the group experienced a tax benefit: The payer deducted at its resident state's regular corporate tax rate, whereas the Dutch recipient included at the lower intragroup rate in the Netherlands. Although the group might receive an overall tax advantage, the commission concluded that the advantage arose from a mismatch, not from state aid granted by the Netherlands. Commission decision (July 2009) on state aid on the *Groepsrentebox* scheme, O.J. L 288, 04.11.2009. In its action for annulment of the commission's *Apple* decision, Ireland argued that the failure to tax all of Apple's income was the result of a mismatch and that "the State aid rules by their nature cannot remedy mismatches between tax systems on a global level." Case T-778/16, *Action for Annulment* (Nov. 9, 2016), *Ireland v. Commission*, 2017 O.J. (C 38) 35. Similarly, while Belgium phrased its pleadings generally, on appeal in the excess profits case, Belgium likely will argue that nontaxation under its excess profits regime was not aid because it arose from a mismatch.

¹⁴⁰ See generally *Starbucks* final, *supra* note 1 (citing both the 1995 OECD transfer pricing guidelines, which the Netherlands had incorporated into domestic law, and the 2010 OECD transfer pricing guidelines, which post-dated the rulings at issue in the case).

¹⁴¹ See, e.g., *Apple* final, *supra* note 1, at paras. 88-89, 272-273, 323.

¹⁴² See generally Tom O'Shea, "An Analysis of Some Apple State Aid Arguments," *Tax Notes Int'l*, Mar. 27, 2017, p. 1155 (detailing retroactive application of OECD standards to the Irish rulings by the commission in *Apple*).

¹⁴³ *Apple* final, *supra* note 1, at para. 153.

¹³⁸ An implication of the *sui generis* arm's-length standard is that Belgium could not exempt excess profits even if it had, contrary to reality, applied the exclusion evenhandedly to domestic and multinational groups.

application of article 7 of the OECD model treaty to determine tax consequences in a situation not governed by article 7.¹⁴⁴

Responding to Ireland's arguments, the commission noted that initial guidance and drafts were available at the time of the second ruling; that PE profits attribution is similar to profits attribution under article 7 of the OECD model (which Ireland had in its tax treaties at the time of the Apple ruling); and that "no other alternative detailed and comprehensive analyses on methods of attributing profits are available."¹⁴⁵ Ireland complained that the commission imposed "an external reference framework,"¹⁴⁶ particularly because even as late as 2016 — the year of the commission's final decision in *Apple* — Ireland had yet to endorse the OECD PE profits attribution report as its method for attributing profits to Irish PEs.¹⁴⁷

The commission avoids irksome retroactivity problems by citing OECD guidance not because the state endorsed it or incorporated it into domestic law, but rather because OECD guidance sheds light on the independent state-aid-specific arm's-length allocation standard that applies in every case.¹⁴⁸ Thus, OECD guidance becomes a "non-binding" "focal point" that "is the result of expert discussions," with the added bonus (but not necessity) that many states actually adopt it into law.¹⁴⁹ For the same reasons, the *sui generis* arm's-length standard enables the commission to apply OECD guidance in situations not covered by tax treaties, as it did in *Apple*.¹⁵⁰

Although the commission recently stated that adherence to the OECD guidelines normally will shield member states from adverse state aid

decisions, it left open the possibility that adherence may be insufficient to avoid a finding of state aid.¹⁵¹

IV. Basis of *Sui Generis* ALS

The commission's derivation of the state-aid-specific arm's-length allocation rule rests on three arguments.

The first argument, which is independent of the other two, involves the commission's conflation of two different kinds of arm's-length standards.

The second argument is that stand-alone domestic companies are the appropriate comparator for determining whether a state properly allocated income to a multinational group (or the branch of a nonresident company). The commission reasons that if taxation of stand-alone domestic companies constitutes the correct reference base for multinationals, a member state must use arm's length to calculate the income of multinationals, just as the state requires stand-alone companies to report their income as earned in actual arm's-length transactions.

Third, the commission claims that *Forum 187*, a CJEU decision from 2006, provides support for the independent arm's-length standard.

Finally, this part reviews other recent CJEU case law that bears on whether the Court will uphold the independent arm's-length standard.

The next section, Section V, argues that the EU courts should reject the first argument, but that the second will be harder for the member states to defeat. The fate of the third argument depends on what the CJEU really meant in *Forum 187*. While the commission's view is plausible, the analysis it cites from *Forum 187* is ambiguous.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at para. 322.

¹⁴⁶ *Id.* at para. 178.

¹⁴⁷ *Id.* at para. 197.

¹⁴⁸ The commission explained that to the extent it refers to the OECD framework in its decision, it does so "because that framework provides value guidance on whether a method for determining the taxable profit of a branch produces a reliable approximation of a market-based outcome in line with the arm's length principle, since it is the result of expert discussions in the context of the OECD and it elaborates on techniques aimed to address common challenges in international taxation." *Id.* at para. 441.

¹⁴⁹ *Id.* at para. 79; *Starbucks* final, *supra* note 1, at para. 66; *Fiat* final, *supra* note 1, at para. 88.

¹⁵⁰ See *supra* Sections II.D and III.

¹⁵¹ 2016 notice, *supra* note 12, at para. 173 ("If a transfer pricing arrangement complies with the guidance provided by the OECD Transfer Pricing Guidelines, including the guidance on the choice of the most appropriate method and leading to a reliable approximation of a market based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State aid.").

A. Two Ships Called Arm's Length

The first premise for the independent state aid arm's-length allocation standard involves a mix-up. The state aid rules require states to hold enterprises at arm's length, and this requirement applies in both tax and nontax cases.¹⁵² The mix-up arises when the commission draws on this state-to-enterprise arm's-length requirement to support its *sui generis* income allocation arm's-length requirement. The commission thus seems to confuse two different arm's-length standards.¹⁵³ I refer to arm's-length income allocation rules as pocket-to-pocket arm's length to emphasize that the concept does not involve the relationship between the state and the enterprise.

The well-supported state-to-enterprise arm's-length standard, which goes under various names in state aid doctrine, including the market economy operator test, requires member states to hold enterprises at arm's length.¹⁵⁴ But despite the commission's arguments about *Forum 187*, which I discuss later,¹⁵⁵ no clear precedent supports the notion that independently of member state domestic law, the state aid rules require parts of an enterprise to hold each other at arm's length.¹⁵⁶ Nor have the state aid rules — until now — been interpreted to mean that member states must, as a matter of state aid law, impose pocket-to-pocket arm's-length rules on their enterprises.¹⁵⁷

B. Stand-Alone Company Reference Base

The commission's second argument for a state-aid-specific arm's-length income allocation

standard derives from its choice of a stand-alone company reference base.

In each of the cases discussed here, the commission concluded that the appropriate reference base was the tax rules for stand-alone companies engaged only in domestic economic activity.¹⁵⁸ Because stand-alone companies engage in transactions only with third parties, by definition their income and expenses reflect market prices. Thus, states do not violate the state-to-enterprise arm's-length principle when they calculate the taxable income of stand-alone companies using actual market prices.

The commission acknowledged that prices and income allocation between parts of a group are not actually subject to market discipline and instead are subject to manipulation by the taxpayer. Thus, the commission acknowledged that states cannot simply accept multinationals' reported profits. But because the commission concluded that income calculation for stand-alone companies represented the reference base, and because income calculation for stand-alone companies depends on actual market transactions, the commission concluded that to avoid state aid, member states had to calculate multinationals' income in a manner that comes as close as possible to market transactions.¹⁵⁹

In the commission's view, the best method to approximate a "market-based outcome" for multinationals was arm's-length transfer pricing.¹⁶⁰ Thus, the commission translated

¹⁵² *Id.* at paras. 73-114.

¹⁵³ Mason, "Part 4," *supra* note 4.

¹⁵⁴ See, e.g., 2016 notice, *supra* note 12, at paras. 73-114 (explaining the market economy operator test and how to apply it in various contexts).

¹⁵⁵ See *infra* Section IV.C.

¹⁵⁶ Although the CJEU endorsed the arm's-length income allocation standard in *Forum 187*, in that case the member state had itself adopted the standard in domestic law. Joined Cases C-182/03 and C-217/03, *Forum 187 ASBL*, EU:C:2006:416.

¹⁵⁷ Indeed, in the fundamental freedoms context, the CJEU repeatedly has disclaimed that the TFEU provides guidance about how member states should allocate income from cross-border transactions. See Mason, "Part 3," *supra* note 4, at 748.

¹⁵⁸ See, e.g., *Starbucks* final, *supra* note 1, at para. 244. Cf. *Fiat* final, *supra* note 1, at para. 215 (concluding that the reference system is the general Luxembourg corporate income tax system "irrespective of whether corporate income tax is imposed on the profit of group or stand-alone companies"). In *Apple*, the commission concluded that nonresident companies with domestic branches (so-called integrated companies) were properly compared with stand-alone domestic companies (so-called non-integrated companies). See *Apple* final, *supra* note 1, at para. 253.

¹⁵⁹ See, e.g., *id.* at para. 253 ("A non-integrated company's taxable profit is determined by prices dictated by the market. . . . Consequently, to ensure that a profit allocation method endorsed by a tax ruling does not selectively advantage a non-resident company operating through a branch in Ireland, that method must ensure that that branch's taxable profit . . . is determined in a manner that reliably approximates a market-based outcome in line with the arm's length principle.").

¹⁶⁰ *Starbucks* final, *supra* note 1, at paras. 263-267; *Fiat* final, *supra* note 1, at paras. 227-231; *Excess Profits* final, *supra* note 1, at paras. 149-156; *Apple* final, *supra* note 1, at paras. 253-261.

income determined under actual market conditions for stand-alone companies into a requirement for income allocated *only* at arm's length for multinationals. Moreover, any interpretation or application of the arm's-length principle that did not approximate a market outcome would be illegal aid to the extent that it reduced tax liability.¹⁶¹

The commission rests its reference base argument on an identity of purpose in states' assessment of corporate taxes for stand-alone domestic companies and multinationals — namely, the commission understands the purpose of the corporate tax in both contexts to be to tax the “profit of all companies subject to tax in” the relevant member state.¹⁶²

C. 'Free Competition' in *Forum 187* (2006)

The final source for the commission's independent arm's-length standard is *Forum 187*, a 2006 state aid case decided by the CJEU.¹⁶³ In *Forum 187*, the Court affirmed the commission's finding that Belgium granted state aid through tax rulings issued under the Belgian coordination center regime. Under that regime, Belgium granted select companies (coordination centers) rulings that deviated from the OECD transfer pricing guidelines.¹⁶⁴ The rulings for the coordination centers deviated from the guidelines in myriad ways. For example, Belgium allowed coordination centers to exclude specific costs when they calculated income according to the

cost-plus method.¹⁶⁵ Belgium also often allowed coordination centers to use a fixed markup of 8 percent to calculate their income under cost-plus.¹⁶⁶ OECD guidance authorized neither the exclusion of the costs nor the fixed markup.¹⁶⁷

The CJEU agreed in *Forum 187* that the commission properly compared Belgium's transfer pricing regime for coordination centers with “the ordinary tax system, based on the difference between [the income and expenses] of an undertaking carrying on its activities in conditions of free competition.”¹⁶⁸

That language can be taken as modest support for the commission's approach in the current cases that compares income allocations for multinationals with income calculations for stand-alone domestic companies.¹⁶⁹

In the recent cases, however, the commission construes “conditions of free competition” to mean only one thing: Income allocations must be judged by an independent arm's-length standard that applies regardless of whether the member state adopted any arm's-length standard into domestic law.¹⁷⁰ Thus, the commission asserts that the CJEU in *Forum 187* interpreted the state aid

¹⁶¹ Under this view, it is hard to see how the base erosion and profit-shifting project's patent box approach, with its formulary elements and optional “uplift” that allows states to increase tax benefits on the basis of an arbitrary percentage of expenses, could possibly pass muster under the state aid rules, despite the Code of Conduct Group's apparent approval of it. See generally Lilian V. Faulhaber, “The Luxembourg Effect: Patent Boxes and the Limits of International Cooperation,” 101 *Minn. L. Rev.* 1641-1702 (2017).

¹⁶² See, e.g., *Apple* final, *supra* note 1, at para. 228; see also *Starbucks* final, *supra* note 1, at paras. 244-249 (arguing that the purpose of Dutch transfer pricing rules was to “align the tax treatment of related companies with the treatment of unrelated companies”).

¹⁶³ Joined Cases C-182/03 and C-217/03, *Forum 187 ASBL*, EU:C:2006:416.

¹⁶⁴ *Forum 187*, para. 6 (“A centre must first receive individual authorisation by royal decree. In order to obtain that authorisation, the centre must form part of a multinational group with capital and reserves of at least BEF 1,000 million and an annual consolidated turnover of at least BEF 10,000 million. Only certain preparatory, auxiliary and centralisation activities are authorised, and undertakings in the financial sector are excluded from the regime. At the end of the first two years of their activity, centres must have in Belgium at least the equivalent of 10 full-time employees.”).

¹⁶⁵ *Forum 187*, para. 9 (“A centre's taxable income is determined at a standard rate according to the cost-plus method. It represents a percentage of the total operating expenses and costs, from which staff costs, financial charges and corporation tax are excluded.”).

¹⁶⁶ *Forum 187*, para. 100.

¹⁶⁷ Commission Decision 2003/757 (Feb. 17, 2003) on the aid scheme implemented by Belgium for coordination centres established in Belgium, 2003 O.J. (L 282) 25, at para. 89 (*Forum 187* final).

¹⁶⁸ *Id.* at para. 95. The bracketed language fixes a mistranslation into English from the authoritative French. See Haslehner, *supra* note 22, at 150-151.

¹⁶⁹ Even this support is not unambiguous, because it is unclear whether the court approved of comparing income allocation for coordination centers with income allocation for stand-alone companies because (1) those groups are always comparable for state aid purposes or because (2) Belgium itself incorporated the arm's-length standard into its domestic rules for coordination centers when it adopted the OECD cost-plus method for those companies and, according to the OECD, cost-plus was meant to achieve income results similar to those for stand-alone companies (*i.e.*, arm's length).

¹⁷⁰ *Starbucks* final, *supra* note 1, at paras. 258-264; *Fiat* final, *supra* note 1, at paras. 223-228; *Excess Profits* final, *supra* note 1, at paras. 145-151; *Apple* final, *supra* note 1, at paras. 249-257.

rules to mandate that states allocate income through this independent arm's-length standard.¹⁷¹ That view departs from the traditional method of identifying tax state aid, which relies on deviations from a domestic law reference base.¹⁷²

The language the commission relies on in *Forum 187* consists of only a few paragraphs¹⁷³ in a case in which no party disputed that the correct reference base was the OECD guidelines.¹⁷⁴ I argue that those paragraphs are ambiguous because the Court's use of "conditions of free competition" is susceptible to multiple interpretations.

1. As domestic law arm's length.

First, the CJEU could have used the phrase "the ordinary tax system, based on the difference between [the income and expenses] of an undertaking carrying on its activities in conditions of free competition" to describe Belgium's domestic law reference base.

According to Advocate General Philippe Léger in his *Forum 187* opinion, "conditions of free competition" was a description of the goals underlying OECD methods, including cost-plus, that had been developed to allocate taxable income.¹⁷⁵ In Léger's view, that goal, and OECD guidance in general, were relevant to the case,

because Belgium derived the cost-plus method it applied as part of the coordination center regime from the OECD.¹⁷⁶ Belgium had thus made it part of the domestic law regime under scrutiny.¹⁷⁷ The CJEU took the same view.¹⁷⁸

It is therefore ambiguous whether Léger's and the Court's approving references to income calculations under "the ordinary tax system, based on the difference between [the income and expenses] of an undertaking carrying on its activities in conditions of free competition" represents a description of the goals of cost-plus, as adopted into Belgian domestic law, or the standard to be applied in every state aid case regardless of domestic law.

The commission ignores this ambiguity and takes *Forum 187* to "endorse the arm's length principle as the benchmark for establishing whether a group company receives an advantage."¹⁷⁹ A more modest interpretation is that arm's length is merely a benchmark that was

¹⁷¹ *Starbucks* final, *supra* note 1, at paras. 258-264; *Fiat* final, *supra* note 1, at paras. 223-228; *Excess Profits* final, *supra* note 1, at paras. 145-151; *Apple* final, *supra* note 1, at paras. 249-257. See also *Apple* final, *supra* note 1, at paras. 154-155 (noting Ireland's objections that it did not use the OECD arm's-length standard to attribute profits to a PE and that that standard was not adopted by the OECD until 2010, after the challenged rulings were issued).

¹⁷² A discrimination approach would compare the member state's actual treatment of the favored class of taxpayers (here, coordination centers) with the member state's actual treatment of the disfavored set of taxpayers (here, companies that did not qualify as coordination centers). It would therefore use a domestic law, not a normative, base for comparison.

¹⁷³ *Forum 187*, paras. 94-96.

¹⁷⁴ Joined Cases C-182/03 and C-217/03, *Forum 187 ASBL* (opinion of Léger) EU:C:2006:89, para. 257 (noting that "Forum 187 does not appear to challenge the fact that whether or not an advantage exists falls to be assessed on the basis of the criterion which underlies the OECD's 'cost-plus' method").

¹⁷⁵ *Forum 187* (opinion of Léger), para. 246 (noting that the aim of the OECD methods, including cost-plus, "is that the prices charged should correspond to those which would apply in normal conditions of competition").

¹⁷⁶ *Forum 187* (opinion of Léger), para. 245 (noting that the Belgian coordination center regime was "based on the so called 'cost-plus' method, which is one of the systems recommended by the" OECD).

¹⁷⁷ See, e.g., *Forum 187* (opinion of Léger), para. 247 (noting that the commission concluded that because Belgium allowed coordination centers to exclude costs from the cost-plus method, Belgium coordination centers' taxable income "is not calculated in such a way that services provided by the coordination centres are to be taxed as if they were supplied by another company, in a context of free competition, pursuant to the principle underlying the OECD's 'cost-plus' method").

¹⁷⁸ The CJEU described the cost-plus method of the Belgian coordination center regime as deriving from OECD guidance. *Forum 187*, para. 94 ("That method of assessment of taxable income is based on the so-called cost-plus method recommended by the [OECD] for the taxation of services provided by a subsidiary or a fixed establishment on behalf of companies belonging to the same international group and established in other States."). Immediately thereafter, the Court approvingly cited the commission's comparison of results under the coordination center regime with income calculated as the "difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition." *Id.* at para. 95. But it is unclear whether the Court meant that arm's length is inherent in the state aid rules, or that arm's length applied in *Forum 187* because Belgium adopted it in domestic law when it adopted cost-plus.

¹⁷⁹ *Fiat* final, *supra* note 1, at para. 225 (emphasis added). See also *Starbucks* final, *supra* note 1, at para. 261; and *Apple* final, *supra* note 1, at para. 251.

relevant in *Forum 187* because Belgium adopted it as part of its coordination center regime.¹⁸⁰ It is ambiguous in *Forum 187* whether the arm's-length standard served as the benchmark because Belgium incorporated the OECD arm's-length standard into its domestic law or, as the commission now insists, because there exists an exogenous, normative arm's-length standard that applies as an independent state aid standard in every case, even if the member state never adopted it into domestic law.¹⁸¹

Another way of putting this question would be to ask: Did Belgium lose *Forum 187* because it

deviated from its own income allocation rules (which required OECD cost-plus)¹⁸² or instead because it deviated from a normative conception of what those allocation rules ought to be? Only the second scenario would support the *sui generis* arm's-length standard.

2. As an absence of state aid.

Another interpretation of the “free competition” language in *Forum 187* is plausible. Instead of referring exclusively to a state-aid-specific arm's-length allocation requirement that applies in every case, “conditions of free competition” could also refer to any method of income allocation that does not involve state aid. Under this view, free competition is just competition not tilted by the member state in favor of a select enterprise (or enterprises).¹⁸³ On this interpretation, “free competition” would simply be an antonym for state aid. One presumes that a state could arrive at a result consistent with free competition (in this sense) through more routes than just the arm's-length standard. Formulary apportionment or other methods of allocation may also generate results consistent with free competition, as long as those methods do not involve the state privileging some enterprises over similar others.

These other possible interpretations call into question the commission's interpretation of *Forum 187* to impose a uniform arm's-length income allocation mandate on the member states, regardless of whether those states incorporated arm's-length concepts into domestic law.

¹⁸⁰ All of the commission, Léger, and the CJEU understood Belgium to have adopted OECD arm's-length principles for application to coordination centers. See *supra* notes 173-177. At the time of *Forum 187*, Belgium also would have applied the arm's-length standard in the treaty context. *Forum 187*, *supra* note 163, at para. 43 (citing No 26/48 of the *Commentaar van het Wetboek van de Inkomstenbelastingen 1992* (commentary on the income tax code) for the proposition that “when determining transfer prices, the Belgian administration must base itself on the OECD reports”).

Although it is not clear that any of the commission, Léger, or the CJEU was aware of the fact, Belgium did not expressly adopt the arm's-length method outside the tax treaty and coordination center contexts until 2004, after the facts of *Forum 187* arose. In 2004 Belgium adopted arm's length for multinationals in all situations. See *Excess Profits* final, *supra* note 1, at para. 29. Although Belgian statutes did not expressly refer to “arm's-length” outside the tax treaty and coordination center contexts before 2004, Belgian domestic law incorporated arm's-length principles. See, e.g., Case C-311/08, SGI, EU:C:2010:26 (analyzing long-standing Belgian domestic law (art. 26 CIR 92) that allowed the state to reallocate income in cases of gratuitous or unusual cross-border payments made to commonly controlled parties). A transfer was unusual if “contrary to the normal course of events and established business rules and practice, in the light of the prevailing economic circumstances and the financial situation of the parties.” *Id.* at para. 4. A transfer was gratuitous when “granted in the absence of any obligation or consideration.” *Id.* See also administrative circular (June 28, 1999), Circulaire n AAF/98-0003 dd.28.06.1999 (French version), Fisonetplus, at II.3. A. (Dec. 1, 2017) (interpreting a Belgian statute, art. 26 CIR 92, to require application of the arm's-length method for domestic income allocation, and repeatedly referring to the 1995 OECD transfer pricing guidelines). See also Jacques Malherbe and Ruben De Boeck, “The Belgian Experience,” in *Multilingual Texts and Interpretation of Tax Treaties in EC Tax Law* 31 n.90 (2005) (“In Belgium, the term ‘at arm's length transaction’ is not used. Instead Arts. 26, 79, and 207 speak of ‘abnormal and fortuitous advantages.’”).

¹⁸¹ Analogous support for the first interpretation can be found in Belgium's objection to the commission's findings on distortion of competition (rather than selectivity). Belgium complained that “the Commission's position that the scheme in question should be examined solely in the context of the ordinary tax legislation currently applicable in Belgium is unacceptable.” *Forum 187*, *supra* note 163, at para. 51 (arguing that the right comparator was the treatment of coordination centers by other member states).

¹⁸² See Raymond Lujá, “State Aid Benchmarking and Tax Rulings: Can We Keep It Simple?” in *State Aid Law and Business Taxation* 117-119 (2016).

¹⁸³ Léger understood the goal of cost-plus (and other OECD methods) to determine income “in such a way that services provided by the coordination centres are to be taxed as if they were supplied by another company, in a context of free competition.” Joined Cases C-182/03 and C-217/03, *Forum 187* (opinion of Léger), EU:C:2006:89, para. 274. Thus, Léger refers to “free competition” as deriving from OECD guidance rather than from the state aid principles. But for it to serve as a reference base for state aid purposes, in Léger's view, the OECD free competition standard evidently had to itself comply with the state aid rules. We know this because Léger noted that if were shown that OECD-compliant cost-plus (rather than the noncompliant variant that Belgium actually used for coordination centers) would result in an “unduly high” tax base for coordination centers, it “would show that the ‘costplus’ method is not appropriate for establishing the transfer prices of the coordination centres.” *Id.* at para. 260. Thus, even though all the OECD methods purport to produce arm's-length results, Léger seemed to allow that as applied, some methods might violate the state aid rules.

D. Other CJEU Precedent

In addition to *Forum 187*, a pair of recent cases strikes me as relevant for predicting whether the CJEU will ratify the commission's imposition of an independent arm's-length income allocation standard on the member states.

1. Gibraltar (2011).

Decided in 2011, *Gibraltar* is the most far-reaching tax state aid case.¹⁸⁴ The CJEU considered whether the commission erred by holding that the entire proposed Gibraltar corporate tax system would constitute state aid if enacted.¹⁸⁵ Under the proposed regime, which by its terms would have applied to "all companies,"¹⁸⁶ Gibraltar would levy a registration fee, a property tax, and a payroll tax. The commission reasoned that the property and payroll taxes constituted selective advantages because they would effectively exempt offshore companies, which typically had no payroll or property in Gibraltar.

The lower EU court, the General Court, vacated the commission's decision.¹⁸⁷ The General Court held that because the payroll and property taxes constituted part of the reference base, the exemption of offshore companies did not constitute a deviation and therefore could not be aid.

The commission argued that the reference base was irrelevant. It maintained that it was not required to identify a reference base in a case in which the entire tax regime discriminated,¹⁸⁸ a situation that could be discerned by looking at the anticipated effects of the regime, not just the language of the statute. Thus, the entire Gibraltar regime — rather than a deviating part of it — constituted the selective advantage.

¹⁸⁴ Joined Cases C-106/09 P and C-107/09 P, *Gibraltar*, EU:C:2011:732 (involving the commission's evaluation of a proposed tax regime as state aid).

¹⁸⁵ The case involved a proposed regime, and the approval of the commission was sought for the regime before enactment, as required by state aid law. TFEU art. 108(3) ("The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid.").

¹⁸⁶ Joined Cases C-106/09 P and C-107/09 P, *Gibraltar*, EU:C:2011:732 para. 12.

¹⁸⁷ See *id.* at para. 37. The United Kingdom appealed on behalf of Gibraltar, one of its overseas territories. Spain intervened on the side of the commission. Ireland intervened to support the United Kingdom and Gibraltar.

¹⁸⁸ *Id.* para. 49.

The CJEU rejected the General Court's analysis and sided with the commission.¹⁸⁹ Although the CJEU claimed that the commission had in fact used a domestic law reference base,¹⁹⁰ it also declared that rigidly tying the commission to the reference base approach would allow regimes that "inherently discriminated" to avoid state aid enforcement.¹⁹¹

The Court emphasized that the purported "objective of the proposed tax reform [was to] introduce a general system of taxation for all companies established in Gibraltar."¹⁹² But the proposed regime would not actually achieve that goal because it contained only property and payroll taxes, while lacking "a generally applicable basis of assessment providing for the taxation of all companies covered by that regime."¹⁹³

Gibraltar is a bad precedent for any state defending itself from an adverse state aid decision, because it expands the commission's enforcement discretion by unmooring the state aid concept from the domestic law reference base. That's just what the commission seeks to do by applying a state-aid-specific arm's-length standard that is independent of domestic law. In *Gibraltar*, the CJEU ratified the commission's total departure from the domestic law reference base approach. In the current cases, the Court may likewise be willing to agree that when the commission uses a reference base, it can choose between a domestic law reference base and a normative reference base, presumably depending on which would better serve state aid goals.

¹⁸⁹ *Id.* 90-91.

¹⁹⁰ See *id.* at para. 95 (noting that the commission had identified a valid baseline — the tax of onshore companies — against which the tax of offshore companies was selective).

¹⁹¹ *Id.* para. 92 (limiting the commission to the reference base approach would mean that "national tax rules fall from the outset outside the scope of control of State aid merely because they were adopted under a different regulatory technique although they produce the same effects in law and/or in fact").

¹⁹² *Id.* at para. 101. The commission noted that "the stated aim of the reform is to adopt a new general corporate tax scheme that does not involve any element of State aid, to provide legal certainty for companies active in Gibraltar and to ensure sufficient revenue for the Gibraltar Government from company taxation," deliver compliance with the EU code of conduct, and eliminate "all discrimination between resident and non-resident, or domestic and non-domestic economic activity, i.e., the elimination of so-called ring-fencing provisions."

¹⁹³ *Id.* at para. 100.

In one sense, *Gibraltar* represents a radical break with past state aid enforcement in the tax area because the commission invented (and the CJEU approved) a new method for identifying state aid. At the same time, however, Gibraltar engaged in exactly the kind of tax competition that the commission increasingly uses the state aid rules to combat.¹⁹⁴ Intervening in the case, Spain noted that Gibraltar's "real objective" was to attract foreign capital by investors seeking to avoid tax in their country of origin.¹⁹⁵ That claim can hardly be disputed. By clever tax base definition, Gibraltar essentially devised a ring-fenced exemption for offshore companies. And by using the state aid rules to strike the proposed regime, the commission did precisely what it set out in the 1998 notice to do (with the council's blessing) — namely, enforce the EU Code of Conduct's otherwise unenforceable resolution against harmful tax competition.¹⁹⁶

So far, the CJEU has declined to extend *Gibraltar* because of its unique features, including that Gibraltar designed its entire regime to benefit a discreet "privileged category" of undertakings — namely, offshore companies.¹⁹⁷ Moreover, the current cases do not directly implicate *Gibraltar* because the commission claimed to follow the reference base approach in all of them. Perhaps for this reason, Treasury did not even discuss *Gibraltar* in its white paper on state aid.¹⁹⁸ But a lesson from *Gibraltar* is that the commission and the CJEU know state aid when they see it, and they are prepared to prohibit it under novel theories if precedents and published guidance are unable to supply established methods. This puts very broad enforcement powers into the hands of

the commission and should make defenders of member state tax rulings uneasy, especially when those rulings suggest that the state deliberately aided taxpayers in avoiding other states' taxes. Time will reveal the full impact of *Gibraltar*.

2. *Aer Lingus* (2016).

The second recent case that bears on whether the commission can develop a normative income allocation rule is *Aer Lingus*, decided in 2016.¹⁹⁹ In that case, the CJEU rejected the idea that advantages for state aid purposes should be measured by a hypothetical, rather than an actual, reference base. Generalizing that approach would mean that if the commission uses the reference base approach, it must use the state's actual law as the reference base rather than an idealized state-aid-specific arm's-length standard.²⁰⁰ *Aer Lingus* is a favorable precedent for the appealing Member States and taxpayers because in all the recent cases, the commission purports to use the reference base approach.

Aer Lingus involved Irish airline taxes. Ireland required airlines to collect an air travel tax on flights originating in Ireland. The tax was €2 for flights within 300 kilometers of Dublin, and otherwise it was €10. The commission launched a state aid investigation, but before the conclusion of that investigation, Ireland set the tax at €3 for all flights, regardless of destination.

The commission proceeded with its investigation for the period that Ireland had the two-tiered tax. A major question in the case was what baseline the commission should use in determining whether Ireland granted airlines a favorable deviation.

One possibility was that the reference rate should be €2, because Ireland collected at least that much on every trip and it was thus the most generally applicable tax. On a €2 reference rate, Ireland would have granted no state aid. (Rather, Ireland likely would have violated the prohibition on tax discrimination under the fundamental freedoms each time it collected the €10 tax. That would mean that Ireland would have to refund

¹⁹⁴ The proposed Gibraltar rules were internally consistent; if the Gibraltar regime were universalized, all income would be taxed exactly once. No company — no matter where it resided or where it held its factors of production — would be favored over any other, except to the extent that tax rates varied, but such variation is permissible under EU law.

¹⁹⁵ *Gibraltar*, at para. 56.

¹⁹⁶ For the history of state aid enforcement in the business tax area, see Mason, "Tax Rulings as State Aid FAQ," *supra* note 4.

¹⁹⁷ Joined Cases C 20/15 P and C 21/15 P, *World Duty Free Group*, EU:C:2016:981, paras. 73-74.

¹⁹⁸ Treasury, "The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings" (Aug. 24, 2016). Presumably, Treasury omitted *Gibraltar* because its goal was to persuade the commission that recovery would be inconsistent with the commission's own past practice, including its past practice of regarding "advantage" separately from "selectivity."

¹⁹⁹ Joined Cases C 164/15 P and C 165/15 P, *Aer Lingus*, EU:C:2016:990.

²⁰⁰ If that is correct, the Court could limit the use of normative reference bases to cases like *Gibraltar*, in which the entire regime was purportedly "inherently discriminatory." *Gibraltar*, at para. 49.

the difference, €8, to the airlines that paid the higher fee.)

Instead, the commission decided that the reference rate was €10, which meant that Ireland conferred state aid on the airlines every time it assessed tax at only €2, and Ireland had to recover the difference from the airlines. The commission concluded that the higher rate was the proper reference rate because the lower rate applied only in exceptional circumstances, namely, short-haul flights.

Setting aside the troublesome question of how to choose a reference base in a rate case,²⁰¹ *Aer Lingus* is a helpful precedent for member states arguing against the commission's imposition of an exogenous reference base. The airlines argued in *Aer Lingus* that the reference base should have been €3, the tax rate that Ireland presumably would have assessed across the board if it knew the two-tiered rate structure was illegal.²⁰² Under this conception, the difference between €3 and €2 would have been state aid for airlines that paid the €2, and Ireland would have had to recover it from the airlines. (Under the same conception, airlines that paid the €10 tax presumably would have experienced taxation that discriminated in violation of the fundamental freedoms, and if their claim was successful, Ireland would have had to refund to them the difference between €10 and €3.)

But the CJEU rejected the €3 reference base argument because that base relied on counterfactual reasoning.²⁰³ Although it did not involve tax base definition or income allocation rules, *Aer Lingus* is a good case for taxpayers and

²⁰¹ *Aer Lingus*, at para. 42. Ryan Air argued that there was never a "normal" or "reference" rate under the Irish system, which always had two rates. *Id.* at para. 47.

²⁰² *Id.* at para. 54. Another argument was that the commission should have reduced the recovery to account for the fact that the €10 fee was a violation of the fundamental freedoms that would have to be refunded by Ireland to the airlines that collected it. *Id.* at paras. 61-65. Finally, the airlines argued that only the part of the tax that was not passed on to passengers should be recovered. The CJEU rejected all three of the airlines' arguments. It noted that incidence doesn't matter. *Id.* at para. 102. Also, it held that the national court had the responsibility to ensure that any subsequent compensation under the fundamental freedoms to the airlines for paying the higher tax "does not give rise to new aid . . . to the benefit of the undertakings receiving such reimbursement." *Id.* at para. 119.

²⁰³ *Aer Lingus*, para. 52 ("fixing a reference rate other than that actually applied during the period in question would not allow all the effects of [the contested tax] to be fully apprehended") (citing opinion of Mengozzi).

states because it favors use of the state's actual rules as the reference base instead of hypothetical rules the state could have adopted. In his opinion in *Aer Lingus*, Advocate General Paolo Mengozzi argued that had the Court accepted the airlines' argument, it "would have the paradoxical effect of defining as 'normal' a rate of tax to which none of the undertakings concerned were subject during the reference period."²⁰⁴ Using a normative allocation rule as the reference base instead of the state's own actual allocation rules would have the same effect: It would apply the state-aid-specific arm's-length rule only to taxpayers whose rulings were investigated by the commission, whereas the state's domestic law income allocation rule would apply to all other taxpayers.

3. Fundamental freedoms precedent.

More generally, the commission's claim that TFEU article 107 requires the member states to adopt a specific income allocation rule lacks adequate support, particularly in light of the CJEU's repeated assertions in fundamental freedoms cases that the TFEU provides no insight about how member states should allocate income among themselves, other than that the allocation rules they choose must comply with EU law.²⁰⁵ It would be strange at this late date for the CJEU to find that the treaty allows states to use only arm's length.

V. Prospects on Appeal

To the extent that the commission's decisions rely on conflation of the state-to-enterprise arm's-length standard with pocket-to-pocket arm's-length, they should be overturned.

In addition to lacking support in the TFEU or judicial doctrine, the commission's assertion that the state aid rules require states to impose pocket-to-pocket arm's length, regardless of domestic law, leads to absurd results. For example, it would mean that a member state's unilateral adoption of the commission's own common consolidated corporate tax base (CCCTB) proposal, which would allocate multinationals' income among the states by formula apportionment, would convey

²⁰⁴ Joined Cases C 164/15 P and C 165/15 P, *Aer Lingus* (opinion of Mengozzi), EU:C:2016:515, para. 41.

²⁰⁵ See Mason, "Part 4," *supra* note 4, at 957-961.

illegal aid whenever the proposed formula resulted in less liability for a company than the company would have under the commission's pocket-to-pocket arm's-length standard.²⁰⁶

Likewise, for the reasons given above, the commission stands on shaky ground when it relies on *Forum 187* to support its *sui generis* arm's-length income allocation standard. But there are too few business tax state aid cases for me to predict whether the CJEU will accept or reject the commission's plausible, if not slam-dunk, interpretation of *Forum 187*.

In my view, the commission's strongest argument for using an arm's-length standard in state aid cases derives from the commission's selection of stand-alone companies as the reference base. The member states reject the stand-alone company reference base, arguing that differences in their legal entitlement to tax domestic and multinationals companies necessitate different allocation rules for each.²⁰⁷ The member states therefore contend that the correct reference base in judging whether a particular ruling confers aid is whether that ruling comports with that country's treatment of other multinationals.²⁰⁸ In other words, as long as the challenged member state adhered to its own transfer pricing rules (which in most cases was the

contemporaneous OECD arm's-length standard), then, the states argue, the commission should find no aid.

The commission was not unsympathetic to the notion that member states must treat multinationals and stand-alone companies differently. It rightly acknowledged that avoiding double taxation and countering abusive income shifting could justify differences in income calculation between domestic and multinational taxpayers.²⁰⁹ Thus, the commission acknowledged that the income calculation approach for stand-alone companies might have to be adjusted for multinationals, but it rejected the notion that stand-alone companies would form no part of the reference base.

The commission seems to me to have the better argument on this point. The problem with the member states' view that the proper reference base consists of the states' tax treatment of only other multinationals is that although it would prevent member states from preferring some multinationals over others, it would not preclude member states from systematically preferring multinationals over stand-alone domestic companies. The state aid rules were designed to prevent such favoritism.²¹⁰ Thus, it is unlikely that the CJEU would accept that member states can have one standard for multinationals but a different (and not equivalent) standard for stand-alone companies. The real question, then, is whether only the commission's *sui generis* arm's-length standard is capable of allocating income to multinationals in a way that does not favor them over stand-alone domestic companies.

In other words, even if the CJEU agrees with the commission that domestic stand-alone companies are the appropriate reference base in state aid cases involving allocation of income to multinationals, that does not mean that the CJEU must endorse the commission's *sui generis* arm's-length standard. Rather, the Court should be willing to accept any faithfully applied allocation rule that does not inherently prefer multinationals to stand-alone companies.

²⁰⁶ For more on this argument, see Mason, "Part 3," *supra* note 4. The CCCTB proposal would apply only to multinationals; the income of domestic stand-alone companies would continue to be calculated based on actual market transactions, an outcome that, if adopted unilaterally, would be illegal aid under the Commission's stand-alone-company reference-base approach, which requires multinationals' income to be calculated under *sui generis* arm's-length. For the latest CCCTB legislative proposal, see Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 final (Oct. 25, 2016). EU-level adoption of CCCTB would presumably not constitute aid because any tax savings it conferred would be imputable to the EU (not to a particular member state) under the reasoning of *Deutsche Bahn*. See Case T-351/02, *Deutsche Bahn AG v. Commission*, EU:T:2006:104 (holding that an allegedly discriminatory German tax exemption could not be analyzed as state aid when it derived from an EU directive because the exemption was not imputable to Germany). This doctrine has been subject to criticism.

²⁰⁷ *Excess Profits* final, *supra* note 1, at para. 80 (Belgian argument that since under domestic law it could tax only the arm's-length profit, Belgium was not allowed to tax excess profit); *Apple* final, *supra* note 1, at para. 195 (arguing that Ireland lacked authority to tax the non-Irish profits of Apple's nonresident affiliates).

²⁰⁸ See, e.g., Irish appeal in *Apple Sales International and Apple Operations Europe v. European Commission*, T-892/16. See also *Starbucks* final, *supra* note 1, at para. 245 (noting Dutch argument that proving selectivity would require evidence that Dutch Starbucks "has received a different treatment as compared to other group entities tax resident in the Netherlands" that were subject to Dutch domestic income allocation rules).

²⁰⁹ See *supra* discussion Section II.

²¹⁰ See Mason, Part 5, *supra* note 4.

Under this analysis, the member states could choose, among other legally permissible allocation rules, formulary or arm's length, even though formulary does not approximate a market-based outcome. If EU law permits member states to choose their allocation rules, the commission's enforcement efforts then would be limited to ensuring that (1) the member state's allocation rule does not itself violate the state aid rules, and (2) the member state consistently applies its chosen allocation rule to all taxpayers without cutting sweetheart deals.

Return to the commission's assertion that the state aid rules require member states to only and always use the *sui generis* arm's-length income allocation standard. Because the member states generally already incorporate OECD arm's-length concepts into domestic law, in most cases there will be little practical difference between the commission's asserted standard and the traditional domestic law reference base approach.

But what's really at stake in these cases is who — the commission or the state itself — gets to choose the income allocation rule. The member states say that they get to choose, and they can choose OECD arm's-length, formulary, or something else, as long as the standard they choose does not itself violate the state aid rules.²¹¹

The commission is not explicit, but its reasoning seems to be that by using separate accounting to tax the net income of stand-alone domestic companies, states automatically triggered application to multinationals of separate accounting with the commission's state-aid-specific arm's-length standard. Under that standard, the state's own income allocation rules — no matter how clear, transparent, and faithfully executed — are illegal unless they lead to a so-called market-based outcome. According to the commission, a market-based outcome can arise only from application of the state-aid-specific arm's-length income allocation standard, and the commission alone is competent to describe that standard.

Notice, however, that the commission's analysis presumably would run differently if the

member states had different income calculation rules for domestic companies. If member states calculated stand-alone domestic companies' income under, for example, formulary apportionment, the commission presumably would not object to states using formulary for multinationals. Thus, use of a stand-alone-company reference base is not fundamentally at odds with the idea that member states are free under the state aid rules to choose their income allocation rules. Instead, use of a stand-alone company reference base leads to the conclusion that member states must, to the extent possible, use the same allocation rules — whatever they may be — for stand-alone and multinational companies.

VI. Superfluosity

The *sui generis* arm's-length standard used by the commission in the recent income allocation cases is not needed to uphold the result in any of them. In *Starbucks* final, *Fiat* final, and *Belgian Excess Profits* final, the commission purported to show that the states violated the *sui generis* arm's-length standard, but it also purported to show that the states violated their own domestic arm's-length standards (which in all three cases the commission concluded was the OECD arm's-length standard applicable at the time of the challenged ruling).²¹²

If the states deviated from their own reference base in favor of particular undertakings, that would be enough under the traditional reference base standard to trigger the remaining step in selectivity analysis. Thus, in three of the cases, the EU courts can sustain the recovery orders on modest grounds without introducing an unpredictable new standard.

This brings us to *Apple* final. That case is tricky for the commission because Ireland apparently did not have clear standards or guidelines for attributing profits of a nonresident company to an Irish PE. In *Apple* final, the commission used the

²¹¹ For my views on state aid limits on states' selection of allocation rules, see Mason, "Part 4," *supra* note 4, at 958-961.

²¹² See, e.g., *Starbucks* final, *supra* note 1, at paras. 409-412. For in-depth analysis of the *Starbucks* final case by a transfer pricing expert, see William Morgan, "Transfer Pricing Methods in the European Commission's Starbucks Case," *Tax Notes Int'l*, May 9, 2016, p. 573 (concluding in part that contrary to the commission's views, the arm's-length method does not require the use of comparable uncontrolled prices over TNMM).

sui generis arm's-length standard to supply the missing reference base. Thus, while the other three cases could be resolved without resorting to the *sui generis* arm's-length standard, the commission may have applied that standard in those three cases as part of an overall strategy to develop a universal reference base that it could use in cases like *Apple* final, in which the conventional domestic-law-reference-base approach was problematic because the state lacked a clear domestic allocation rule.

But even *Apple* final could be resolved through a more conventional approach. The commission examined all of Ireland's PE rulings and found that in all of them, Ireland either accepted the taxpayer's application of the OECD standard or the tax administration exercised unbounded discretion in accepting allocation ruling requests. The latter would make Ireland's PE profits allocation ruling regime state aid under long-standing commission guidance, although it is unclear how the recovery would be calculated.²¹³

The former would mean that even though Ireland never formalized it into domestic law, Ireland's own domestic standard was in fact the OECD arm's-length principle. If this is correct, and if the commission carried its burden to show that the *Apple* rulings deviated from OECD arm's length, then Ireland deviated from its observed (if not statutory) domestic law reference base. Under either of those theories, the CJEU could affirm the commission's decision that Ireland granted aid to *Apple*, while rejecting the commission's *sui generis* arm's-length standard.

One last note on establishing selectivity: The third step in the analysis — after establishing the reference base and the deviation from the reference base — is discrimination. The commission must show that the state granted the benefit to some taxpayers while denying it to comparable others.

There are several ways the commission could establish discrimination in these cases. One kind of potential discrimination is between multinationals that sought rulings and those that

self-assessed under the arm's-length standard. Rooting out this kind of discrimination would seem to target what is most troubling about secret rulings: the possibility that the member state uses them to cut special deals with favorite taxpayers.

Other potential types of discrimination include stand-alone companies versus multinational, domestic versus nonresident, and so on. Right or wrong — reversible error or not — this part of the commission's analysis would be unaffected by the selection of a domestic law rather than a normative income allocation rule as the reference base. Thus, if the commission's assertions are correct that the states violated their own rules, the commission doesn't need the *sui generis* arm's-length standard to reach the conclusion that the states conferred illegal aid.

VII. Conclusion

There have been reports that companies are less likely to seek tax rulings since the commission's investigations.²¹⁴ By itself, a reduction in rulings tells us nothing, other than that taxpayers now face more legal uncertainty in Europe. Taxpayers may engage in equally aggressive tax plans in the absence of rulings, drawing comfort from vigorous member state opposition to the recent commission decisions. What used to be done with a ruling secured in a day's time before the investigations could still be done with self-reporting and a nudge and a wink. Winking self-reporting is just as nontransparent as rulings — even more so, because at least rulings can be exchanged with other countries or discovered by the commission.

The scope of EU state aid enforcement in the tax area is unpredictable. Lawyers in Europe worry that tax policies as quotidian as participation exemption and as central as territoriality may constitute state aid. That legal uncertainty arises partly because the commission uses the state aid rules to pursue several conflicting values, and it does not always specify clearly in each case what value it pursues. The goals of state aid control should be more clearly articulated, and the commission's enforcement

²¹³ Commission notice on application of the state aid rules to measures concerning direct business taxation, 1998 O.J. C-384/03, at paras. 21-22 (Dec. 10, 1998); 2016 notice, *supra* note 12, at paras. 123-125.

²¹⁴ See Stephanie Soong Johnston, "Dispute Resolution Becoming More Difficult, Practitioners Say," *Tax Notes Int'l*, Sept. 5, 2016, p. 854.

actions should be limited by those goals. Those limitations could be self-imposed by the commission, using clearer published guidance and more explicit reasoning in decisions, or those limitations could come from the EU courts through less deferential judicial review of the commission's state aid decisions.

At least in part, the state aid prohibition seems to be the inverse of the nondiscrimination principle under the fundamental freedoms.²¹⁵ While the fundamental freedoms prohibit a state from discriminating *against* cross-border commerce over domestic commerce, the state aid rules prohibit a state from discriminating *in favor* of cross-border commerce over domestic commerce.²¹⁶ If true, this interpretation could help clarify how the state aid rules should be interpreted and help clarify when two taxpayers are comparable.²¹⁷ The commission's appropriate goal of eliminating sweetheart rulings would fit comfortably within that interpretation.²¹⁸

Over the last four decades, as the CJEU has decided myriad tax cases, observers of EU tax doctrine have come to understand the bargain struck by the member states in the TFEU in a particular way. When the member states joined the EU, they gave up their entitlement to use their tax systems to discriminate, at least when that discrimination would undermine the common market in violation of the fundamental freedoms or prohibition on state aid. Thus, member states

cannot use taxes to discriminate on the bases of sector, size, region, nationality, or engagement in cross-border commerce. At the same time that they ceded tax sovereignty, however, the states retained authority to define their tax bases (including their allocation rules) and set their tax rates, provided they did not discriminate on impermissible bases. By imposing a normative income allocation rule, the recent state aid cases call into question this accepted understanding of the impact of EU law on Member State tax powers. ■

²¹⁵ See Case C518/13, *Eventech*, EU:C:2015:9, para. 53; Joined Cases C-106/09 P and C-107/09 P, *Gibraltar*, EU:C:2011:732, para. 101; Case C-15/14 P, *Commission v. MOL* (opinion of Wahl), EU:C:2015:32, para. 54; and Case C270/15 P, *Belgium v. Commission* (opinion of Bobek) EU:C:2016:289, para. 29. This statement is only a partial description. It applies to the aspect of state aid rules that prohibits export subsidies, but it does not apply to the aspect that prohibits, say, sectoral or regional aid. See generally Mason, "An American View," *supra* note 4.

²¹⁶ Joined Cases C 20/15 P and C 21/15 P, *World Duty Free Group* (opinion of Wathelet) EU:C:2016:624, para. 137 (citations deleted, emphasis added).

²¹⁷ Much has been written on how to identify discrimination against cross-border commerce. See, e.g., Mason and Michael S. Knoll, "What Is Tax Discrimination?" 121 *Yale L.J.* 1014 (2012).

²¹⁸ At a tax conference, Max Lienemeyer, head of sector in the Task Force Tax Planning Practices of the European Commission's Competition Directorate General, suggested that the main concern about tax rulings was that states use them to prefer particular companies. He said, "We are just looking at where tax authorities have clearly gone beyond the normal application of the rules and given certain deals to some companies that they don't give to others." Santhie L. Goundar, "European Commission Defends State Aid Investigations," *Tax Notes Int'l*, June 27, 2017, p. 1238. Countering Lienemeyer's legitimate concerns about sweetheart rulings does not require exogenous standards.