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Transfer Pricing Rules and State Aid

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Abstract

The purpose of this Essay is to place in context the four investigations currently open in relation to tax rulings on transfer pricing and to explore the manner in which proceedings of this kind may serve to correct abuses in international taxation practice.

KEYWORDS: Apple, Ireland, Luxembourg, Amazon, Netherlands, Starbucks, Transfer Pricing, European Commission, European Coal and Steel Community Treaty

ARTICLE

TRANSFER PRICING RULES AND STATE AID

Richard Lyal[*]

INTRODUCTION

On June 11, 2014, the European Commission initiated State aid proceedings against three Member States in respect of advance tax rulings granted in relation to the transfer pricing practices of certain multinational groups (Ireland—Apple;[1] Luxembourg—Fiat;[2] and the Netherlands—Starbucks).[3] It adopted a fourth decision in the same series on October 7, 2014 (Luxembourg—Amazon).[4] On February 3,

[*]Principal Legal Adviser, European Commission. The views expressed in this Essay are the Author's alone and should not be attributed to his employer. The Author would like to underline his own gratitude and admiration for Pieter Jan Kuijper, who during his time in the Commission's Legal Service was a source of support and inspiration for younger colleagues.

1. Commission Notice, 2014 O.J. C 369/22.
2. Commission Notice, 2014 O.J. C 369/37.
3. Commission Notice, 2014 O.J. C 460/11.
4. Commission Notice, 2014 O.J. C 44/13.

2015, the Commission issued a further opening decision concerning tax rulings (Belgium—Excess profits).[5]

In a period of heightened sensitivity towards the manner in which multinational groups arrange their affairs and a widespread public perception that these groups do not pay their "fair share of tax," these decisions have attracted a certain amount of attention. They may be seen in a broader context encompassing the Base Erosion and Profit Shifting ("BEPS") project currently under way in the Organization for Economic Cooperation and Development (the "OECD")[6] and the Commission's initiatives aimed at greater tax transparency, including information on tax rulings.[7] Thus the adoption of the three decisions on June 11, 2014 was accompanied by declarations from the members of the Commission responsible for competition and for taxation regarding the need to ensure fair application of tax rules in the interest of a level playing-field for business.[8] Other declarations have emphasised a link between taxation and the location of economic activity.[9]

Although the public attention these decisions have received may be something of a novelty, the decisions themselves do not represent a new departure in State aid practice. On the contrary, they are simply a further step in a long development of case law and decision-making practice which began in the era of the European Coal and Steel Community ("ECSC") Treaty. If there was ever a new departure, it took place in the late 1990s, when increased interest in the possible

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5. Commission Press Release, IP/15/4080 (Feb. 3, 2015). This decision deals not with transfer pricing issues but with a scheme under which companies taxable in Belgium which are members of multinational groups are permitted to deduct from their taxable profits amounts which exceed the profits that the company would have earned as a stand-alone entity and are attributable to synergies or to the distribution of tasks within the corporate group. Since the content of the last decision is not publicly available at time of writing it will not be discussed in this Essay.

6. Including the global standard on exchange of information between tax authorities, now incorporated in EU legislation. *See* Council Directive 2014/107/EU of 9 December 2014 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, 2014 O.J. L 359/1.

7. *See* Commission of the European Communities, An Action Plan to strengthen the fight against tax fraud and tax evasion, COM (2012) 722 Final (Dec. 12, 2012); Commission of the European Communities, Proposal for a Council Directive amending Directive 2011/16/EU, as regards mandatory automatic exchange of information in the field of taxation, COM (2015) 135 Final (Mar. 18, 2015); Commission of the European Communities, Communication from the Commission to the European Parliament and the Council on tax transparency to fight tax evasion and avoidance, COM (2015) 136 Final (Mar. 18, 2015).

8. *See* Commission Press Release IP/14/663 (June 11, 2014).

9. *See* Commission Press Release IP/15/4610 (Mar. 18, 2015).

distortive effect of tax measures in the internal market led the Member States to agree to the Code of Conduct for Business Taxation,[10] and the Commission to issue its Notice on the application of the State aid rules to measures relating to direct business taxation.[11] In line with its commitment made at the time to apply the State aid rules strictly in this field,[12] the Commission examined a large number of national tax measures, including many of those identified as harmful by the Code of Conduct Group set up by the Member States.

Nor is this the first time the Commission has examined tax rulings or transfer pricing from a State aid perspective. In 2003 it issued a number of decisions concerning tax schemes on transfer pricing involving individual rulings in favour of companies. One example is a Belgian tax ruling scheme for the foreign sales subsidiaries of US companies.[13] The Commission considered that the application of a flat rate margin of 8% to a restricted set of costs did not represent a genuine assessment of the level of profit that an independent company could be expected to earn from comparable activities.

The recently opened proceedings thus have a long pedigree. In the light of the attention they have provoked, it may be useful to understand how the State aid rules are to be applied in the field of taxation, and what their relevance may be in seeking to counter tax evasion and avoidance. While the function of State aid control is not, or at least not primarily, to ensure that tax is paid in the proper place, it has a contribution to make where a tax avoidance scheme of an undertaking depends in part on the cooperation of State authorities. The purpose of this Essay is to place in context the four investigations currently open in relation to tax rulings on transfer pricing and to explore the manner in which proceedings of this kind may serve to correct abuses in international taxation practice.

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10. Council Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy, O.J. 1998 C 2/1 [hereinafter Council Conclusions].

11. Commission Notice, 1998 O.J. C 384/3.

12. *See* Council Conclusions, *supra* note 10, at 5.

13. *See* Commission Decision No. 2004/77/EC (Belgium – Tax ruling system for United States foreign sales corporations), 2004 O.J. L 23/14, ¶¶ 12-18, 47-48; *see also* Commission Decision No. 2003/438/EC (Luxembourg – Finance companies), 2003 O.J. L 153/40, ¶ 42; Commission Decision No. 2003/512/EC (Germany – control and coordination centres), 2003 O.J. L 177/17, ¶ 26; Commission Decision No. 2004/76/EC (France – Headquarters and logistics centres), 2004 O.J. L 23/1, ¶¶ 7-9, 51-53.

I. *BACKGROUND AND FACTS—WHAT ARE THESE CASES ABOUT?*

The function of tax rulings on transfer pricing—also called "advance pricing arrangements"—is to provide legal certainty to the undertakings concerned on the tax treatment of transfers of goods and services between companies which are members of the same corporate group—or in some cases between establishments of a single company in different countries.

In very broad terms the taxable profit of a company is its total revenue—sales and other income—less the cost of obtaining that income. Among the costs to be deducted are amounts paid for goods and services purchased. Where a company buys goods or services from an unrelated seller, or borrows money from a bank, there is little scope for debate as to the reality of the expense. The same is true, on the profit side, where goods or services are supplied to an unrelated purchaser. But where transactions take place between companies under common control, the price of transactions can be manipulated in order to allow the group as a whole to lessen its tax burden, by shifting revenue to low-tax countries, and over-stating costs in high-tax countries. Tax authorities and legislators are naturally aware of this risk, so tax legislation typically allows the authorities to correct the tax declarations of companies by substituting prices which correspond to those which would be charged under market conditions. The principle is also included in Article 9(1) of the OECD Model Tax Convention on Income and on Capital.[14]

It is not solely transactions with related companies that pose problems of this kind. Essentially the same problem arises in the relations between a company and its permanent establishment in another country. The branch will normally be taxed in the State of

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14. *See* OECD, Model Convention With Respect to Taxes on Income and on Capital, art. 9(1) [hereinafter OECD Model]. The Model Convention states:

> Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

establishment as if it were an independent business entity.[15] The branch may be required to maintain separate accounts in that State, in which case the pricing of transfers between the branch and the head office will be subject to scrutiny. If there are no separate accounts, a method must be found to identify the profits of the company that are attributable to its business activity in the country of the branch. Again, the guiding principle is the arm's-length concept, the need to identify the level of profits that would be achieved under market conditions.[16]

Depending on the types of transactions in question and the degree to which the company under examination operates on the market at all, the determination of prices equivalent to those which would prevail on the market—arm's-length prices—may be a difficult exercise. The Transfer Pricing Guidelines[17] drawn up by the OECD recognize five methods, of which three are regarded as traditional transaction methods and two are considered transactional profit methods:

> (1) Comparable uncontrolled price ("CUP"): the simplest and most intuitively satisfactory method compares the price charged between related companies with the price observed in comparable transactions between unrelated companies.
>
> (2) Resale price: here it is not the price but the gross margin that is compared. Where a product is bought from a related company and sold to an unrelated company, the arm's-length price of the transaction between the related companies is arrived by subtracting from the resale price a margin corresponding to those realised in comparable transactions involving unrelated companies.

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15. *See id.* at art. 7(2). Article 7(2) states:

> For the purposes of this Article . . . the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

16. *Cf.* OECD, 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (July 22, 2010), *available at* http://www.oecd.org/ctp/transfer-pricing/45689524.pdf.

17. *See* OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (Aug. 18, 2010), *available at* http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm. The transfer pricing guidelines were first published in 1995.

(3) Cost plus: again, a method based on margins but in the opposite direction. The arm's-length price for an onward sale of goods or services to a related company is arrived at by adding an appropriate mark-up—reflecting the margin applied in comparable transactions between unrelated companies—to the costs incurred by the seller.

(4) Transactional net margin method ("TNMM"): rather than the price of transactions, this method assesses the level of net profits. It takes an appropriate base such as costs, turnover or fixed investment and applies a profit ratio reflecting that observed in comparable uncontrolled transactions.

(5) Transactional profit split: this method takes the combined profits of two related undertakings and divides them according to the resources used by the parties and their respective functions, taking into account, where possible, external data such as the division of profits in comparable joint ventures.

The OECD guidelines are naturally not binding, but they represent the result of long discussion and a certain consensus on the most appropriate ways of estimating an arm's length price or level of profit. They are thus a point of reference for national tax authorities in applying the arm's-length principle, and they are explicitly mentioned in the legislation or administrative guidance of many Member States.[18] They have also been taken as a basis for the Commission's analysis in previous State aid cases.[19] The guidelines do not, however, limit the freedom of action of taxpayers, which are normally free to propose a method which diverges from those recommended by the OECD if they consider—and can persuade the tax authorities—that their alternative method results in a robust approximation of an arm's-length price.

The methods set out in the guidelines are not a smorgasbord from which businesses may pick according to their taste or convenience. Different methods are considered appropriate for

18. *See, e.g.*, Taxation (International and Other Provisions) Act 2010, c. 8, § 164 (U.K.); Bulletin BOI-SJ-RES-20-10-20140218, Journal Officiel De La République Française [J.O.] [Official Gazette of France], 18 February 2014 (Fr.); Decree IFZ/2013/184M, 14 November 2013 (Neth.). *See generally* Transfer Pricing Country Profiles, OECD (last updated June 6, 2013), *available at* http://www.oecd.org/ctp/transfer-pricing/transferpricingcountryprofiles.htm.

19. In addition to the decisions cited in *supra* note 13, see, e.g., Commission Decision No. 2003/757/EC (Belgium – Aid Scheme) 2003 O.J. L 282/25 (upheld in Belgium and Forum 187 v. Commission, Joined Cases C-182/03 & C-217/03, [2006] E.C.R. I-5479).

different situations and there is at least an informal hierarchy between them. The traditional transaction methods seek to ascertain a market price for each transaction or set of transactions, and the CUP is considered to provide the closest approximation of a market price. The profit methods, by contrast, estimate the profit that an independent company could be expected to make from a line of business or a business relationship.

The guidelines form a significant part of the Commission's reasoning in the opening decisions under discussion. In summary, the circumstances giving rise to those decisions are the following.

A. *Ireland—Apple*

Among tax planners, Ireland is well known as a base for the technique called "double Irish," which exploits mismatches in the tax treatment of companies that are incorporated in Ireland but not resident there for tax purposes. This case concerns the tax treatment in Ireland itself of two companies (Apple Operations Europe, Apple Sales International) incorporated in Ireland but not tax resident there under Irish rules defining residence.

Apple Operations Europe manufactures personal computers. It purchases components from related companies and sells the finished product to a related company. It also provides certain services for Apple group companies in Europe, the Middle East, and Africa. In 1991 it obtained from the Irish revenue authorities a ruling fixing its net profit at 65% of operating expenses up to an amount of US$60–70 million[20] and 20% of operating costs above that figure. A revised ruling issued in 2007 defined profits as a margin of 10–20% of operating costs together with a return on intellectual property of under 10% of turnover.

Apple Sales International purchases Apple brand goods from third-party manufacturers and sells them on to companies in the Apple group and other customers. A 1991 tax ruling set its net profit at 12.5% of branch operating costs. Under a revised ruling issued in 2007 its profits are deemed to be 8–18% of branch operating costs.

The Commission has expressed doubts. The 1991 rulings do not appear to have been based on any comparability analysis, but instead were the result of negotiation aimed at fixing a narrow range of taxable profits in Ireland. The method applied is a form of TNMM,

20. The precise figures are confidential.

but it is not clear why operating costs are used as the indicator rather than a broader measure such as costs of goods sold, nor indeed why costs are considered the appropriate indicator at all. The discrepancy between the two margins accepted in the 1991 ruling for Apple Operations Europe—65% versus 20%—is hard to explain as an arm's-length calculation, and these figures appear to have been chosen for other reasons. The rulings include capital allowances fixed at a level for which the basis is unexplained. The 1991 rulings remained in force for an unusual length of time. The allocation of profits to the Irish branch of Apple Sales International takes no account of the increase in sales over the period following the 2007 ruling.

B. *Luxembourg—FFT*

The identification of the beneficiary as Fiat Financing and Trade Ltd. is a deduction from the data available. Luxembourg offered limited cooperation during the initial stages of the procedure and refused to identify the company, citing secrecy concerns.

Fiat Financing and Trade ("FFT") is a Fiat subsidiary with its head office in Luxembourg and branches in London and Madrid. It performs central treasury and financing functions for the Fiat Group's operations in Europe—outside Italy—and is the immediate parent company of Fiat Financing North America ("FFNA") and Fiat Financing Canada ("FFC").

In autumn 2012, it obtained from the Luxembourg authorities an advance pricing arrangement valid for a period of three years based on a transfer pricing analysis carried out by FFT's tax advisers. That analysis presented a TNMM calculation based on the application of a fixed rate of return to a portion of the company's equity, resulting in a tax base (taxable income) of some EU€2.5 billion ± EU€10 million in each of the years covered by the tax ruling. The rate of return was based on a comparison with publicly available information on a selection of companies operating independently in the financial sector. That rate of return (6.05%) was applied to the portion of equity supposed to correspond to the minimum capital required of financial institutions by the Basel II criteria.[21] The capital corresponding to the

21. BANK FOR INTERNATIONAL SETTLEMENTS, BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (June 2006), *available at* http://www.bis.org/publ/bcbs128.htm.

equity holdings in FFNA and FFC was left out of account, and the remainder, designated "excess capital" was considered to be remunerated at a rate corresponding to short-term interest rates (0.8%).

In the opening decision the Commission identified a number of points of concern. First, the procedure followed appeared to entail considerable discretion for the tax authorities, in itself a potential source of exceptional treatment. It was questionable whether the retention of a fixed tax base for the duration of the tax ruling could be thought to reflect arm's-length conditions since it did not allow for variations in performance. Methods other than TNMM seemed likely to produce a more reliable result since external points of reference for at least some of the financial activities carried on could be used in a CUP analysis. The rate of return appeared excessively low, as did the portion of equity capital taken as the base for the calculation.

C. *Luxembourg—Amazon*

Amazon has a number of subsidiaries in Luxembourg, most of them members of a fiscal unit headed by Amazon EU Sàrl, a limited company incorporated and resident there. These companies carry on the retail and other business activities of the Amazon group in Europe, notably through retail websites. In particular, Amazon EU Sàrl owns the inventory and earns the profits arising from retail sales.[22] Amazon EU Sàrl is owned by Amazon Europe Technologies Holding SCS, a Luxembourg limited partnership which also licenses intellectual property to Amazon EU Sàrl. The limited partnership is transparent for tax purposes; its income is taxable only in the hands of the partners, three US companies which are neither resident in Luxembourg nor have a permanent establishment there. It is thus not liable for corporation tax or income tax in Luxembourg.

In November 2003, the Luxembourg tax authorities issued a ruling agreeing to the tax treatment of Amazon EU Sàrl proposed by its tax adviser. That ruling has been in force ever since. In essence it fixes the return to Amazon EU Sàrl at the lesser of 4–6%[23] of its total operating expenses and the total EU operating profits of the Amazon

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22. *See* Amazon's evidence given to the House of Commons Public Accounts Committee, Report on HMRC's 2011-2012 Accounts, 2012-13, H.C. (U.K.), *available at* http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/writev/716/m03.htm.

23. The precise figure is confidential.

websites, subject to a floor and a ceiling of 0.45% and 0.55% of Amazon's net EU sales revenue. The amount in excess of that is stated to be the royalty payable to Amazon Europe Technologies Holding SCS for the use of its intellectual property—hence a deductible expense.

The Commission's decision of October 7, 2014 raises a number of issues. There is no indication that Amazon's request was accompanied by a comparability report, and the request was granted in an unusually short time—11 working days—casting doubt on the assessment carried out. The calculation used does not appear to correspond to any of the OECD-approved methods. The royalty is not a function of output, sales, or profits, but is calculated as the residual profit above a certain fixed level. The profit margin of between 4% and 6% seems low, and the cap on profit represented by the figure of 0.55% of net turnover reinforces that perception. Finally, it is unusual that a transfer price ruling should be valid for more than a few years at a time without revision.

D. *Netherlands—Starbucks*

Two subsidiaries of the Starbucks group resident in the Netherlands are responsible for a range of group activities in Europe, the Middle East, and Africa. Both companies are beneficiaries of tax rulings issued by the Netherlands authorities but only one of these rulings is the object of the procedure.

Starbucks Manufacturing BV, a company resident in the Netherlands, is responsible for roasting the coffee used in Starbucks outlets in Europe, the Middle East, and Africa. It buys the coffee beans from a related company and pays another related entity—a UK limited partnership—a royalty for the use of intellectual property. In 2008 it obtained a tax ruling from the Netherlands tax authorities fixing its remuneration as a mark-up of 9–12%[24] on a defined cost base. The ruling applies the TNMM method on the basis of a report submitted by Starbucks Manufacturing's tax adviser. The Commission's doubts are the following: It is not clear that Starbucks Manufacturing is properly to be regarded as a low-risk toll manufacturer so as to justify the low margin applied; the cost base appears to be defined too narrowly since certain items of cost are excluded; and the calculation of the royalty is suspect since it is

24. The precise figure is confidential.

calculated as a residual profit without regard to any of the normal bases of calculation of royalties at arm's-length.

II. *THE PROCEDURE—WHAT IS THE FUNCTION OF THESE DECISIONS?*

The four decisions under discussion represent the second phase in the State aid procedure, the opening of the formal investigation.[25] The Commission may at any time, following a complaint or on its own initiative, examine possible unlawful aid—measures which constitute aid but have not been notified to it in accordance with Article 108(3) TFEU. After an initial examination it may decide that the measure does not constitute aid or that it is compatible with the internal market. If it has doubts, it must initiate proceedings—that is, carry out a formal investigation. The decision opening the procedure must include a preliminary assessment of the existence of aid and indicate any doubts as to the compatibility of the aid with the internal market. The Member State concerned and any interested parties—for example, the beneficiaries of the measure and their competitors—are invited to comment. The Commission may also request information from other sources.[26]

Once it has heard the views of interested parties and obtained the information it thinks necessary, the Commission will adopt a final decision. That decision may find that the measure under examination is not aid, is aid compatible with the internal market—possibly subject to conditions, or is unlawful aid.[27] In the case of unlawful aid, the Commission must require the Member State to recover the aid from the beneficiary, unless recovery would be contrary to general principles of EU law or the prescription period of ten years has elapsed.[28] For that purpose it must either identify the amount of the aid to be recovered or provide the Member State with the criteria

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25. *See* Consolidated Version of the Treaty on the Functioning of the European Union art. 108(2), 2008 O.J. C 115/47, at 92 [hereinafter TFEU]; *see also* Council Regulation No. 659/1999 on laying down detailed rules for the application of Article 108 of the Treaty on the functioning of the European Union, 1999 O.J. L 83/1, art. 6 [hereinafter Procedural Regulation].

26. *See* Procedural Regulation, *supra* note 25, arts. 4(2), 4(3), 4(4), 6(a), in conjunction with *id.* art. 13(1).

27. *Id.* art. 7, again in conjunction with *id.* art. 13(1), .

28. *Id.* arts. 14, 15.

necessary for the latter to calculate the amount of that aid.[29] The Member State is required to take all measures necessary for recovery of the aid.[30]

III. *THE ANALYTICAL FRAMEWORK—WHAT IS FISCAL STATE AID?*

Article 107(1) of the TFEU forbids "aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods."

It is well established that State aid has four elements: (1) there must be an advantage; (2) that advantage must be selective; (3) it must be provided from State resources; and (4) it must have an impact—at least potential—on competition and on trade between Member States. The crucial issue in fiscal State aid is material selectivity, the demonstration that certain undertakings enjoy an advantage that is not normally available.

State aid is the provision by the State of financial assistance to a business entity. The most apparent form of financial assistance is naturally a cash subsidy, but it can manifest itself in any form of transfer. In particular it can consist in what is sometimes called tax expenditure, waiving payment of a tax or other charge that would normally be payable.

As the Court of Justice put it in one of its earliest judgments on the subject:[31]

> The concept of aid is . . . wider than that of a subsidy because it embraces not only positive benefits, such as subsidies themselves, but also interventions 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.

29. Spain v. Commission, Case C-480/98, [2000] E.C.R. I-8717, ¶ 25. *See generally* Commission Notice, 2007 O.J. C 272/05 [hereinafter Effective Implementation of Commission Decisions].

30. *See, e.g.*, Mediaset SpA v. Ministero dello Sviluppo economico, Case C-69/13, [2014] (Judgment delivered February 13, 2014), ¶ 23.

31. Gezamenlijke Steenkolenmijnen in Limburg v. High Authority, Case C-30/59, [1961] E.C.R. 1.

Aspects of this statement continue to be recycled in fiscal aid cases today.[32] It is in essence a statement of common sense: there is no difference between receiving a sum of money and being dispensed from payment of a sum of money that would normally be payable. The same idea is found in the WTO Agreement on Subsidies and Countervailing Measures. There, the definition of a subsidy includes a situation where "government revenue that is otherwise due is forgone or not collected (*e.g.*, fiscal incentives such as tax credits)."[33]

The critical element in those definitions is the word "normally" in "normally payable" or "normally included in the budget." It highlights the difficulty of identifying fiscal aid, a more complicated task than identifying a subsidy: first it is necessary to determine the point of comparison.

The most straightforward way of doing that is to identify the generally applicable rule in relation to the tax concerned. Any deviation from that rule may then be considered—at least *prima facie*—to be an alleviation of a financial burden that would otherwise be borne by the taxpayer, and hence to be State aid. That is the approach that has been taken by the Commission in the vast majority of cases and has been confirmed by the Court of Justice.[34] It has the virtue of simplicity and clarity, and it is usually satisfactory for systems of tax whose main purpose is revenue generation, such as corporation tax or value added tax—although there are cases where it breaks down: see Joined Cases C-106 and 107/09 *Gibraltar*, discussed below.

An early example of this approach in the case law is Case 173/73 *Italy v. Commission*,[35] which also lays down other essential principles such as the idea that Article 107 is not concerned with the cause, or the aim, or the type of measure, but with its effects.

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32. *See, e.g.*, Adria-Wien Pipeline GmbH v. Finanzlandesdirektion für Kärnten, Case C-143/99 [2001] E.C.R. I-8365, ¶ 38; Commission v. Gibraltar, Joined Cases C-106/09 & C-107/09, [2011] E.C.R. I-11113, ¶ 71.

33. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS 231 (1999), 1869 U.N.T.S. 14., art. 1.1(a)(1)(ii).

34. *See* Commission Notice, 1998 O.J. C 384/3, ¶ 16 [hereinafter Direct Business Taxation] (a draft notice on the notion of State aid is currently under discussion and may be seen on the website of the Commission's Directorate General for Competition); Italy v. Commission, Case C-66/02, [2005] E.C.R. I-10901, ¶ 100; *Forum 187*, Joined Cases C-182/03 & C-217/03, [2003] E.C.R. I-6887, ¶¶ 119-20.

35. Italy v. Commission, Case 173/73, [1974] E.C.R. 709.

> 13 The aim of Article 92 [now, 107] is to prevent trade between Member States from being affected by benefits granted by the public authorities which, in various forms, distort or threaten to distort competition by favouring certain undertakings or the production of certain goods.
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> Accordingly, Article 92 does not distinguish between the measures of State intervention concerned by reference to their causes or aims but defines them in relation to their effects.
>
> Consequently, the alleged fiscal nature or social aim of the measure in issue cannot suffice to shield it from the application of Article 92.[36]

This case concerned a scheme under which employers in the textiles sector paid a reduced rate of social security contributions. Italy argued that the scheme was appropriate for two reasons: first, the sector was characterised by a high proportion of female labour—since workers were not heads of household they were not eligible for family allowances. Secondly, the industry was particularly open to foreign competition, and contributions were lower in other Member States. According to the Court of Justice, the first argument was irrelevant and the second simply emphasised the fact that the scheme constituted State aid.

That approach may not always be appropriate, since the function of taxation is not solely revenue generation. Taxation is frequently used as an instrument of behaviour modification or as a Pigouvian tool, used to correct what is regarded as an instance of market failure—for example, carbon taxation insofar as it attempts to deal with environment-related externalities.

Where taxation has a regulatory function, a definition of "normal" in terms of the tax measure itself is less satisfactory. It is arguable that the very fact that some people are taxed under that measure and others are not already incorporates preferential treatment of certain businesses. Indeed, it could be said that as soon as tax is used for anything other than revenue-gathering there is scope for a State aid analysis, since any attempt to modify economic incentives by means of taxation may imply State aid to some category of economic operators. Taken to its logical extreme, that could lead to extensive intervention of State aid control in the economic policy of Member States, perhaps in circumstances where that policy is

36. *Id.* ¶ 13.

essentially neutral in its effect. It is not clear just to what extent the scope and purpose of the State aid provisions of the Treaty justify such intervention. However, these issues do not arise in the present discussion, which relates to possible divergence from the norm in the application of a revenue-gathering tax.

Under the approach typically applied by the Commission and by the Court of Justice, the identification of a derogation or a departure from the normal scheme of taxation raises three issues: the existence of an advantage, the selective character of that advantage, and consistency with the nature and logic of the system. An advantage lies in relief from a tax charge that is normally borne. Examples given in the 1998 Commission Notice include a reduction in the tax base (deductions, accelerated depreciation), a reduction in the amount of tax (exemption or credit), or special payment modalities (deferment). These examples show that the notion of an advantage is already a relative concept, since it represents a departure from something that is "normal."[37] There is thus considerable overlap with the notion of selectivity.

This first issue is merely a gateway: there would be no debate if there were no advantage. The core idea of a derogation is found in the next issue, selectivity. According to the Court of Justice it is necessary to assess whether, under a particular statutory scheme, a State measure is such as to "favour certain undertakings or the production of certain goods" in comparison with other undertakings which, in the light of the objective of the system, are in a comparable legal and factual situation. By contrast, measures which apply in the same manner to all economic operators are in principle general measures. The Commission Notice adds the rider that such measures must not be *de facto* confined to certain firms. Member States remain free to decide on their economic policy and to distribute the tax burden as they see fit over different factors of production.

What that typically means in practice is a three-step process:

> 1. Determine the system of reference
>
> 2. Identify a measure or a rule which represents a departure from that system, by giving more favorable treatment to some undertakings than to others. That leads to a conclusion of *prima facie* selectivity.

37. *See, e.g.*, Commission v. Portugal, Case C-88/03, [2006] E.C.R. I-7115, ¶ 56.

3. Then check whether this *prima facie* selectivity can be justified by the logic of the tax system (its nature or general scheme).

According to the Court, "the concept of State aid does not refer to State measures which differentiate between undertakings and which are, therefore, prima facie selective where that differentiation arises from the nature or the overall structure of the system of which they form part."[38] In that statement there is an echo of the Court's reasoning in its case law on the application of the Treaty freedoms in the tax field, and that should be no surprise—in both contexts, what is at issue is fundamentally a question of discrimination.

In relation to a general tax such as income tax or corporation tax, the first step is to take the tax itself as the system of reference. A derogation from the system is a difference in treatment which does not correspond to a relevant difference between taxpayers, having regard to the objective of the tax. Such a derogation amounts *prima facie* to a selective advantage, but it is still necessary to determine whether there is an explanation for the derogation in the logic of the system.

One example might be a progressive income tax. The system of reference is the income tax. The objective of this system of reference is to tax income. Low income earners and high income earners are in a comparable situation in the light of this objective. Therefore, the progressive rates grant an advantage to low income earners. There is *prima facie* selectivity. However, the Member State can show that this selectivity is justified by a guiding principle of its tax system, namely the principles of redistribution and taxation according to the ability to pay.[39]

The concept of the nature or general scheme of the system is one that does not appear in the Treaty. It serves to ensure that regard is properly had to the internal logic of the tax system even where a difference in treatment suggests at first sight a derogation. Consistency with this internal logic demonstrates that a provision is general in nature and aimed at ensuring true equality of treatment for taxpayers, not providing a special favor for some. Thus the adaptation of tax provisions to take into account the particular features of a category of taxpayers such as financial institutions—for example,

38. *Id.* ¶ 52.

39. *Cf.* Territorio Histórico de Álava v. Commission, Joined Cases T-92/00 & T-103/00, [2002] E.C.R. II-1385, ¶ 60.

through recognition of reserve requirements—does not necessarily represent a special measure in favour of that category.[40]

This concept has been created in the case-law and has not always been used with the greatest clarity. In particular, it is not always clear whether the Court has in mind the nature or general scheme of the tax system as a whole, the particular tax in issue, the particular tax regime in issue or indeed the nature or general scheme of any system, whether fiscal or not.

One may ask what justification there is for the separate treatment of these second and third stages. After all, they amount to answering the discrimination question twice over. That is why it is not wholly unjustifiable to suggest that there is no real distinction between the two stages. First of all, however, there is some utility in distinguishing between the fundamental objective of the tax system and other, secondary considerations that have a role to play. Secondly, there is an important procedural aspect. According to established case law,[41] at the third stage it is for the Member State to demonstrate that the apparent discrimination, the *prima facie* selectivity, in reality reflects the logic of the tax system as a whole. In that respect the Court distinguishes objectives which are extrinsic to the tax system from the mechanisms which are inherent in the tax system and are necessary for the achievement of its objectives.

One example of the application of this process may be seen in Joined Cases T-92/00 and T-103/00 *Territorio Histórico de Álava*.[42] That judgment concerned part of a complicated case which had tax and non-tax aspects.[43] One tax aspect was a tax credit for large investments which entailed some discretion for the tax authorities. The Province of Alava argued that this tax credit did not constitute aid since it was a general measure applicable to all investments of an amount in excess of 2.5 billion pesetas—roughly EU€15 million. Moreover, it was consistent with the nature and scheme of the tax system since it was based on objective criteria applicable to all economic operators that fulfilled them.

40. *Cf. Italy*, [2005], E.C.R. I-10901, ¶ 101.

41. *Portugal*, [2006] E.C.R. I-7115, ¶ 81.

42. *Territorio Histórico de Álava*, [2002] E.C.R. II-1385; upheld by the Court of Justice, Case C-186/02, [2004] ECR I-10653.

43. Commission Decision No. 2000/795/EC (Ramondín SA and Ramondín Cápsulas SA), 2000 O.J. L 318/36.

The Court of First Instance reiterated established case law to the effect that a measure is selective when the administration has discretion in the application of the measure and can therefore make more or less arbitrary distinctions among candidates. The measure was also *de facto* selective because of the minimum investment requirement: the benefit was reserved for companies with deep pockets. In response to the argument on the nature and scheme of the tax system the Court considered that if anything, the measure was contrary to the scheme of the tax system since it provided a benefit only for those with most resources. The further argument raised by the Province of Alava that the measure promoted the economic development of the Basque Country was irrelevant to the issue of selectivity since it referred to a matter extraneous to the tax system—this argument would naturally be relevant to the question whether the aid was compatible with the common market.

Two remarks should be made in relation to the first and second steps in the process. First, in determining the reference system it may not always be clear what is the rule and what is the exception. An example of that dilemma may be seen in Case C-6/12 *P*.[44] The relevant national law allowed companies to carry forward losses to subsequent tax periods. It also permitted the transfer of losses between members of a corporate group. However, in order to prevent what was regarded as undesirable "loss trafficking"—the purchase of a loss-making company for the purpose of setting off its losses against the profits of the purchaser—the legislature prohibited the further use of losses following the sale of a company. That was then found to be an excessive response because it prevented the subsequent use of losses in many cases where there was no reason to suspect abuse—for example, the start-up losses of a new company which was taken over by a new investor. In order to correct that problem a new rule was enacted in order to allow some cases through the net. However, the new rule was not clearly formulated and left considerable discretion to the tax authorities. Administrative guidance indicated that aspects such as employment were to be taken into account.

In the *P* case the Court criticized the excessive discretion enjoyed by the tax authorities and the reference to extrinsic objectives. It accepted, however, that an authorization system

44. P, Case C-6/12, [2013], (delivered July 18, 2013); *cf.* Commission Decision No. 2011/527/EU (*Sanierungsklausel*), 2011 O.J. L 235/26.

permitting tax carry-forward only in certain cases was permissible where it was based on the application of objective criteria aimed at preventing trade in losses—paragraph 26 of the judgment. More generally it may be considered that in circumstances of this kind, what is important is consistency. In a case such as *P*, there can be no objection from the State aid perspective if it is shown that the rule distinguishes between abusive and non-abusive conduct, between real economic activity and loss-trafficking. The question, what is the rule and what the exception is in reality of no importance. Such an issue is best dealt with in an analysis of the nature and logic of the system; that underlines the conceptual utility of this third step as a safeguard against mechanical reasoning.

Secondly, the reference, as a point of comparison, to "companies in the same situation" is a dangerous one, for the question is, same situation in relation to what? In principle the comparison should be made with companies which are in the same situation with regard to the logic of the tax system, which means that this is just another way of describing the three-stage process. However, it is all too easy, through this ostensibly innocuous phrase, to introduce extraneous criteria. For example, Joined Cases C-78/08 to C-80/08 *Paint Graphos*[45] concerned a special corporation tax regime (exemption from tax) for producers' and workers' cooperative associations. That was clearly a departure from normal system, and the Court thus dealt quickly with the first two steps in the reasoning (selective advantage). It then addressed the criterion of comparability as a separate issue, saying that cooperatives are different from other economic operators because of the special principles under which they operate: they are managed not in the interest of investors but in that of their members; their shares are not listed and are not easily transferable; they carry on business for the mutual benefit of members; and they typically have a lower profit margin. The Court thus concluded in paragraph 61 of the judgment that cooperatives were not in a comparable factual and legal situation to that of commercial companies.

That does not seem a sound approach, for none of these elements has any obvious relevance to the functioning of the corporation tax system. As the Court went on to observe in paragraphs 69–70 of the judgment, objectives of exemption which are extrinsic to the tax

45. Paint Graphos v. Franchetto, Joined Cases C-78/08 & C-80/08, [2011] E.C.R. I-7611.

system are irrelevant and thus cannot preclude the application of Article 107. The real issue has to do with the nature and logic of the tax system. A cooperative of the kind in question is a group of persons who share infrastructure and facilities, working together but in their own individual interests and sharing the proceeds. It is entirely consistent with the corporation tax system to treat such an entity—despite the fact that it has legal personality—as transparent for tax purposes, in the same way as a partnership. Costs are shared, revenue is shared, and the profit is taxed in the hands of the workers or producers. And the Court appears to accept that view in paragraph 71 of the judgment.

More usually, as for example in Case C-143/99 *Adria-Wien*,[46] the Court speaks in paragraph 41 of companies which "are comparable in the light of the objective pursued by the measure in question." That is not very precise language, and potentially misleading. If the "measure in question" is taken literally to mean the particular rule under examination, then nothing is State aid, for all taxpayers which benefit from the measure are treated equally. The point of comparison must in the first place be the objective of the reference system—taxation of income; taxation of the use of energy, and so on. Thus a better formulation is that used in judgments such as Case C-522/13 *Navantia*,[47] at paragraph 35: "in the light of the objective attributed to the tax system of the Member State concerned."

These remarks reinforce the over-riding importance of the third step, the nature and general scheme of the system, and show that in reality there is no clear division between the various aspects of the debate. The ultimate question is always: does this rule make sense in terms of this tax or of the tax system as a whole? That in turn underlines the need to identify the system to be taken into account. Normally this will be the reference system, but it may at times be necessary to have regard to a wider context. The notion of "the scheme of taxation" may have to be defined quite broadly, as the following example shows.

46. *Adria-Wien Pipeline*, [2001] E.C.R. I-8365, ¶ 41.
47. Navantia v. Concello de Ferrol, Case C-522/13, [2014], (Judgment delivered Oct. 9, 2014).

Case C-308/01 *GIL Insurance*[48] presented a curious situation. The value-added tax legislation of the European Union should in principle apply to all goods and services, but a certain number of services, including insurance, are exempt from value-added tax ("VAT") because it was not possible, when the legislation was being drafted, to find agreement on an appropriate way of calculating the basis of assessment.[49] That is understandable, for it is hard to say just what the price of an insurance service is. It is surely not the amount of the premium, because the largest part of that is a contribution to a common fund set aside to cover risks, and does not represent payment for a service.

Tax advisers in the United Kingdom exploited this exemption by developing a tax avoidance scheme: companies selling large consumer goods on instalment plans would offer extended guarantees worded as insurance policies. Had these been expressed as normal service contracts they would have been subject to VAT at the standard rate of 17.5%; presented as insurance, they were subject to the separate tax on insurance contracts at a much lower rate, 2.5%. The United Kingdom sought to close the loophole by applying a special high rate of insurance tax—by no coincidence 17.5%—to the contracts in question. That measure was challenged on the ground that it constituted State aid to other insurance companies—those paying the normal rate. The Court dismissed that claim, holding that the higher rate should be seen in a broad context encompassing not only the insurance tax but also VAT, for which the insurance tax was a substitute. The difference in taxation was thus justified by the nature and general scheme of the system, the latter being understood in a broad sense.

The three-step model breaks down however in the face of a general tax scheme which is inherently discriminatory, and a striking example of that is Joined Cases C-106/09 and C-107/09 *Commission v. Gibraltar*. For many years Gibraltar had a normal profits-based company tax under which the "offshore economy" enjoyed effective exemption. That system was considered by the Commission to entail State aid. Gibraltar proposed to introduce a new system which

48. GIL Insurance v. Commissioners of Customs and Excise, Case C-308/01, [2004] E.C.R. I-4777.

49. There are in fact two categories of exempt transactions: financial services and insurance, exempted for the reason given, and certain other services which are exempted for reasons of public interest.

consisted in a combination of payroll tax and tax on occupation of business property, with a cap of 15% of income and additional payments for certain types of companies. In essence, it reverse engineered its previous system so as to duplicate its effect in what was ostensibly a single system with no special or exceptional regime.

In a 2005 decision[50] the Commission considered that this "single system" was in fact a combination of different and mutually incompatible taxation schemes, so that it was impossible to identify a reference system and then to discern a "special regime." The scheme as a whole incorporated differentiation between categories of companies in such a way as to provide benefits for some of them, in particular offshore companies. The effects of the scheme were clear: the grant of effective tax exemption to certain categories of companies, in particular those active in the offshore economy—so-called brass plate companies. Indeed, the result of the new system was that there were various tax regimes. Off-shore companies were in general subject only to the payroll tax and thus continued to be exempt, with the exception of those active in the financial sector, which became subject to tax in the amount of about 5%. Companies which actually operated in Gibraltar were subject to tax with a maximum of 15% of profits—so there was essentially a 15% company tax. Companies referred to as utilities—what one might call immobile cash cows—continued to be subject to tax at a rate of 35% of their profits, the standard rate of company tax under the previous system.

The Court of First Instance quashed the Commission's decision on the ground that it had failed to identify a tax regime which gave a special advantage to a certain category of companies.[51] The Court applied the standard approach described above and noted that the Commission had not demonstrated the existence of any departure from a normally applicable set of tax rules. On appeal, the Court of Justice[52] held that the combination of a tax based on payroll—with a threshold depending on profits—and a tax on the occupation of business property was neutral in nature and thus not selective.

50. Commission Decision No. 2005/261/EC of 30 March 2004 (Gibraltar Corporation Tax Reform), 2005 O.J. L 85/1.

51. *See* Gibraltar v. Commission, Joined Cases T-211/04 & T-215/04, [2008] E.C.R. II-3745.

52. *See* Commission v. Gibraltar, Joined Cases C-106/09 & C-107/09, [2011] E.C.R. I-11113.

However, the Commission's failure to obey the standard approach was not necessarily a fatal error. Selectivity can be found in a comparison of the tax burden on different undertakings, the reference framework being the tax system as a whole. A strict requirement to demonstrate a departure from a "normal" regime would leave a loophole which could be exploited. The proposed Gibraltar system would result in *de facto* discrimination between companies in a comparable situation having regard to the objective of a general tax system for all companies. While differences in the tax burden are not in themselves sufficient to demonstrate selectivity, here the exemption of offshore companies was not a random consequence of a dispassionate regime but the desired outcome.

That conclusion is open to criticism insofar as it seems to be based on the purpose rather than the effect of the scheme—although it is well established that a finding of State aid depends not on the objectives of a measure but on its effects.[53] There is also a hint of the circular in its definition of the basis of comparison. Opponents of the standard approach who think that the analysis should always be based on comparability of the situations of taxpayers no doubt welcomed the *Gibraltar* judgment. The standard approach nevertheless has its merits and should be retained unless a robust and reasonably predictable alternative can be found. More general application of the Court's approach in *Gibraltar* would be problematic: it would require careful determination of the basis of comparison and an assessment of the legitimacy of differentiation. In other words, it would require potentially far-reaching intrusion in the tax policy of Member States. It seems preferable to accept that the *Gibraltar* judgment should be confined to a limited range of situations where the standard approach breaks down because it is deliberately subverted.

As a final point, it should be recalled that while this discussion has focused on the existence of aid, that is not the end of the debate in a State aid case. Not all aid is considered undesirable; there is "bad" aid and "good" aid. The latter can be authorized under Article 107(2) and (3) TFEU as compatible with the common market, after examination by the Commission.

53. *See, e.g.*, France Télécom v. Commission, Case C-81/10, [2011] E.C.R. I-12899, ¶ 17.

IV. *TAX RULINGS AS STATE AID—HOW SHOULD THEY BE TREATED FROM THE STATE AID PERSPECTIVE?*

In the light of the foregoing discussion it is clear that advance pricing arrangements, like other measures that fix the obligations of taxpayers, are capable of constituting State aid. The question is, in what circumstances and under what conditions? It should be emphasized first of all that the mere existence of an advance tax ruling, of a system for granting tax rulings, or of legislation that envisages tax rulings, is entirely neutral from a State aid perspective. The function of a tax ruling is in principle to apply the general rules to a particular case, but doing so in advance rather than after the fact and for a more or less prolonged period rather than a single tax year. In this respect there is no difference between a tax ruling given in advance and an individual decision taken after the fact on the taxable income of a taxpayer in a given year. What is important is whether the ruling departs from the normal system of taxation. Only then can there be State aid.

In order to determine whether a ruling entails aid, it is necessary and sufficient to apply the principles set out above. In relation to rulings on transfer pricing—advance pricing arrangements—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 on both sides the elements that are not fixed by the market must be verified and where necessary substituted by a price that corresponds to the price that would be charged in a market transaction. That surrogate for market prices is an arm's-length price which must be arrived at by a uniform and defendable method.

That method, or range of acceptable methods, may be laid down in national legislation. In theory the choice of a method by a Member State is open to State aid scrutiny. A method which was not directed at determining an arm's-length price or one whose systematic result was a price which could not truly be regarded as an approximation of a market price could amount to State aid in so far as it had the effect of diminishing the amount of tax payable by companies forming part on multi-national groups. The sole obstacle to such an analysis (in so far as the method was treated as a tax scheme) would be the reasoning deployed in the recent judgments of the General Court in Case T-

219/10 *Autogrill España v. Commission* and Case T-399/11 *Banco Santander v. Commission*,[54] according to which the concept of selectivity requires the identification of a category of undertakings defined by sector or by the nature of their economic activity.[55]

Equally unacceptable, for obvious reasons, is a system under which the assessment is a matter for the unfettered discretion of the tax authorities. Such a system would offend against established case law according to which State aid exists where the competent authority has latitude to choose beneficiaries or the conditions under which an advantage is granted.[56] Decisions of the tax authorities must be based on an assessment of objective criteria stemming from the logic of the tax system.[57] By contrast, a system which is based on generally accepted methods such as the OECD Guidelines, or any alternative method which is used to calculate an arm's-length price, is not in itself open to objection. Attention must then shift to individual rulings applying a legitimate method.

Here matters become more difficult. From a theoretical perspective it can be said that where the tax authorities apply a transfer-pricing method in such a manner as to procure an undue advantage to an undertaking—for example by using a restricted set of costs in a cost-plus method, or using an inappropriate profit indicator in the context of the TNMM—the result is State aid. The choice of methods itself is not immune from scrutiny; for example, the use of the profit-split method may be considered inappropriate in respect of a company which performs simple transactions for which there is an easily available external comparator. From a policy perspective, however, review of individual decisions represents an intrusion into the freedom of action and of assessment of national tax authorities, and is not a step to be taken without strong grounds.

Indeed in sheer practical terms the task is hazardous, for it is likely to be only in extreme cases that one can with confidence say that a particular decision reflects a misapplication of the chosen method or that it does not truly determine an arm's-length price. The

54. Judgments of 7 November 2014, currently under appeal (cases C-20/15 and C-21/15 respectively). Since the Author is one of the Commission's agents (counsel) in these cases they will not be discussed here.

55. (T-219/10, ¶¶ 34-62; T-399/11, ¶¶ 38-66)

56. *See* France v. Commission, Case C-241/94, [1996] E.C.R. I-4551, ¶¶ 23-24.

57. *See P*, [2013] (delivered July 18, 2013), ¶ 26; *see also* Commission Notice, Direct Business Taxation, footnote 34 *supra*, ¶¶ 21-22.

application of the methods sanctified by the OECD Guidelines is not an exact science and leaves wide scope for the exercise of considered judgment by the tax administration. Even the CUP method, which is generally considered to deliver the most accurate and defendable approximation of market prices, can entail adjustments intended to take into account aspects which distinguish intra-group transactions from market transactions—a comparability analysis may take into account for example the allocation of risk or the performance of functions which do not form part of similar uncontrolled transactions. Methods which entail reference to average values for comparable uncontrolled margins leave scope for even greater uncertainty.

It will be difficult to judge what is State aid and what is a justifiable approximation of an arm's-length price—or in relation to other types of tax ruling, a *bona fide* assessment method aimed at simplification of an otherwise difficult calculation. The burden of proof will always be on the Commission to show that the result arrived at in a specific ruling does not represent the proper application of objective criteria. It is necessary to bear in mind the function of the State aid rules in this context, and the competence of the Commission and the courts in ensuring observance of those rules: it is not for the Commission to police the application of tax rules, nor to substitute its own idea of a good system for that of a Member State. But what the Commission can and must do is check that the transfer pricing methods applied by a Member State do not create an automatic advantage for one or more categories of companies, that accepted methods are applied in a coherent way, and that methods which depart from the norm—where national legislation permits taxpayers to propose alternative methods—nevertheless arrive at a result which is a good or at least defendable approximation of a market price.

The Commission decisions which prompted the present Essay concern individual rulings by national tax authorities. In some respects that facilitates the analysis by the Commission. The sole element that is really in issue is the existence of an advantage in comparison with other companies. Since each ruling concerns a single company there is no need to linger long on the issue of selectivity, and the issue of consistency with the nature and logic of the tax system can hardly be thought to arise.

CONCLUSION

The decisions of the European Commission of June 11, 2014 and October 7, 2014 to open the formal investigation procedure in relation to certain advance pricing arrangements are an indication of its desire to contribute, through the application of the State aid rules, to fair tax competition and to the fight against tax base erosion. There is nothing novel or unconventional in deployment of State aid control in the manner adopted by the Commission in these decisions, irrespective of the particular background. On the contrary, the decisions are firmly in line with previous practice and follow well established principles in the identification of fiscal State aid, notably in the determination of a selective advantage.

It may nevertheless be questioned whether the State aid rules truly provide an appropriate instrument for the control of phenomena such as profit-shifting by multi-national corporate groups. The problem is necessarily a cross-border one—the corporate group derives a benefit from a combination of national tax structures and measures—while State aid analysis looks at a measure of a single State. State aid control cannot, by its nature, capture the exploitation of mismatches between national rules. Moreover, in such a context it may be impossible to demonstrate the renunciation of State resources that would normally be acquired through taxation. For example, in the celebrated double Irish manoeuvre, it is not easy to see where Ireland has lost tax that should normally have been paid there. The very intent of the structure is to escape taxation not in Ireland but in another jurisdiction.

Closer examination of the circumstances lying behind some of the decisions discussed here suggests that in a properly functioning system—and one in which taxation corresponds to the location of economic activity—a certain proportion of the revenue alleged to have been forgone by the national authorities would in fact be taxed elsewhere. That indicates that the underlying problem is one that State aid control is not well fitted to resolve, and indeed such a task lies outside its intended function.