

# **The notion of (fiscal) State aid: decisions of the EU Commission and case law of the EU Courts**

2018

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## **State Aid and Fiscal State Aid – Concept, Elements, EU Legal Framework.**

The first session was opened by Dr Rita Szudoczky, assistant professor at WU University, Vienna. She addressed the concept of State aid and relevance of State aid rules as part of the competition law of the European Union. State aid rules are set forth to regulate State's influences on the competitive conditions in the internal market. Therefore, for the purpose of constraining the Member States from granting undue benefits to certain economic operators and thereby distort competition in the internal market, State aids are – as a general rule – prohibited.

She distinguished between different reasons why governments could decide to support certain enterprises. First, she referred to the correction of market failure, e.g., negative externalities or spill-over effect. Thus, aid may be granted for the aim of increasing environmental standards or encouraging innovation and R&D where market forces would prevent enterprises from investing in the latter (for example, due to prohibitively high costs or the fact that the result of the investment would be exploited by other market players). State intervention may also aim at balancing economic disparities between different regions in the internal market, or at promoting the development of peripheral areas, facilitating access of small enterprises to financial markets. Thus, State aids can have beneficial effects and therefore, under certain conditions, they are compatible with the internal market (see Article 107(2) and (3) TFEU). However, another reason leading governments to grant State aid can be intra-governmental competition. Thus, aid measures may be granted in order to help sustain otherwise inefficient or uncompetitive national companies (national “crown jewels”) at the detriment of other more competitive enterprises from other Member States.

Fiscal aids are desirable to the extent that their beneficial effects on the internal market outweigh deadweight welfare loss associated with taxation (which is required to finance it). Thereto, the main task of the European Commission, in charge of deciding on the compatibility of State aids with the internal market, is to guarantee that those benefit-effects of State intervention indeed offset its negative effect.

However, it is not always clear whether state aids can solve externality problems. Fiscal State aids, i.e. aid measures granted through the tax system, are particularly controversial matters because of the intrinsic complexity of measuring their impact on the market, being practically impossible to have certainty as regards the question whether the positive effect of such State aids indeed outweigh their negative effect.

Szudoczky continued explaining that the European Union is based on the internal market and the definition of the internal market includes a system of competition where all European Union enterprises shall compete with each other under equal conditions. This principle is laid down in the founding treaties,

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in particular, in the Treaty on The Functioning of The European Union (hereinafter TFEU), and in the attached protocols, where the importance of safeguarding the system of competition within the European Union is underlined.

Szudoczky clarified that the general prohibition of granting aid is set out under Articles 107 and 108 TFEU, although by now the legal framework is much more substantial due to the adoption of secondary legislation and soft law instruments. Article 107 (1) TFEU states as follows: “Save otherwise provided in this Treaty, any aid granted by a Member State through state resources in any form whatsoever which distort or threaten to distort competition by favouring certain undertakings or the production of certain goods shall, be incompatible with the common market”. She continued emphasising the phrase under which, “State aid is prohibited in any form whatsoever”. She pointed out that such wording indicates a broad concept of State aid. Indeed, besides cash subsidies, the concept of aid also encompasses for example aid granted through state guarantees granted for certain enterprises under preferential conditions, measures which grant preferential access to public infrastructure below market rate, or financial support granted through fiscal measures.

By reference to the Case C-387/92 Banco Exterior, para 13, she further explained that the Court of Justice was clear from the very beginning on the fact that State aid can be granted not only through cash subsidies but also through tax measures. Indeed, in the aforementioned decision the Court stated that “The concept of Fiscal aid is wider than that of subsidies because it embraces not only positive benefit, such as subsidies themselves but also intervention which, in any 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.”

She then explained that in the last ten years State aid in the form of tax measure has gained increasing importance. One of the reasons why governments might use fiscal support for aiding enterprises is that these are less transparent and difficult to detect.

Szudoczky continued providing a definition of fiscal State aids as a mitigation or a reduction of charges normally imposed to undertakings. Fiscal aid can be granted through a number of different instruments. She first referred to fiscal aid granted through tax legislation, e.g. aid schemes. These measures normally aim at providing benefits accessible, in principle, to an undefined number of undertakings which meet predefined objective conditions. Aid schemes refer to certain intrinsic rules of the tax system of reference seemingly accessible for anyone, but - de facto - working only for the benefit of certain categories or groups of undertakings. Further, fiscal aid may also be granted by tax administrations by assessing tax obligations in a more favourable way only for certain categories of undertakings. In this category, the granting of selective advantage may take the form of a tax ruling. In principle, the purpose of tax rulings should be to bring clarity and certainty on the application of the general tax rules to a certain set of facts and circumstances. Nevertheless, the granting of unlawful aid may derive from the fact that the tax administration deviates from the general tax legislation when issuing a tax ruling. Tax administration can give undue support to certain undertakings or groups of undertakings also through ex-post tax assessments using general rules in a more favourable way for the assessee. Finally, State aid can be granted through tax enforcement when tax administrations decide not to collect tax debts which were assessed according to the law. This occurs, in particular, in the case of tax deferment, tax cancellation or rescheduling of tax debts.

Szudoczky then recalled the definition of Article 107 TFEU, under which, in order for a measure to qualify as a State aid, it must confer an economic advantage, it must be selective, it must be granted through the use of State resources and it must distort or threaten to distort competition affecting intra-Union trade.

By analysing this provision, she explained that the most important, but at the same time most problematic condition enshrined in the concept of State aid is the selectivity element. In the field of fiscal aid, it is particularly difficult to assess this element of the State aid concept. In general, a measure can be selective *de jure* or *de facto*. *De jure* selectivity may result directly from the intrinsic legal criteria adopted by the Member State for granting aids, providing measures *ipso iure* accessible only by certain undertakings or groups of undertakings. By contrast, *de facto* selectivity may be the result of factual conditions, or factual barriers indirectly imposed by the Member States, *de facto* preventing certain undertakings from benefiting from these measures. Szudoczky mentioned different aspects of selectivity, such as sectoral, regional and horizontal selectivity as well as size- or time-dependent selectivity and demonstrated them through various examples. Details about the selectivity of fiscal measures were discussed in the second session.

Finally, as regards the legal framework of the EU State aid regime, an overview was provided of the relevant primary law provisions, secondary legislation (General Block Exemption Regulation, GBER) and the several soft law instruments issued by the European Commission giving guidance on the conditions of compatibility with the internal market of different types of aids. Specifically, with regard to fiscal State aid two soft law instruments were highlighted: the European Commission's 1998 Notice on the application of State aid rules to measures relating to direct business taxation as the first specific guidance on fiscal State aid (hereinafter "1998 Notice") and the Notice on the notion of aid issued in 2016 as new guidance covering, *inter alia*, fiscal State aid.

## **State aid procedure**

The second session was opened by Alexandra Miladinovic, who addressed EU State aid procedural rules. She explained that under Article 108 TFEU the Commission is given exclusive competence to decide on the compatibility of State aid with the internal market. The commission is competent to review existing aid, to take decision on new or altered aid and to take action regarding non-compliance with its decisions or with the requirement as to the notification.

She continued explaining that under the EU law, new aids are negatively defined as all aids which are not existing aid. Conversely, existing aids are aids that already existed prior of the entering in force of the founding treaty in the respective Member States, already authorised aid, and aid that existed from more than ten years. Existing aid also refers to measures that were put into effect at a time when they did not constitute aid, but following developments within the internal market, have subsequently fallen under the provision of Article 107 TFEU.

Pursuant Article 108 (3) TFEU, each new aid need to be notified to the European Commission in sufficient time allowing the Commission itself to gather all the necessary information to enable the decision-making. The Commission must examine whether the measure must be deemed compatible with the internal market. New aids should not be put into effect unless the Commission has taken, or is deemed to have taken, a positive decision. The Commission shall examine the notification taking a decision within a time limit of two months. At this stage, the Commission supervising activity may have three possible outcomes. The measure is considered to not constitute aid, the measure is deemed aid but

compatible with the internal market or formal investigation is started. When the Commission decided to initiate a formal investigation procedure, it is expected to gather all the necessary additional information from the Member State and/or from the undertaking concerned in order to come to a final decision within the following eighteen months. The final decision on the compatibility of the measure with the EU State aid rules may have four further different outcomes. The aid is considered to not constitute aid; the measure is deemed compatible aid; the Commission may attach conditions to the positive decision; the Commission issues a negative decision.

In order to challenge Commission negative decisions, EU procedural rules also offer instruments for the addressee addressed with the negative decision. Pursuant Art. 263 (4) TFEU, “Any natural or legal person may, under the conditions laid down in the first and second paragraphs, institute proceedings against an act addressed to that person or which is of direct and individual concern to them, and against a regulatory act which is of direct concern to them and does not entail implementing measures”.<sup>2</sup> Accordingly, the action for annulment must be brought before the General Court, as the court of the first instance, either by the Member State or by the direct beneficiary of the measure, provided that it is directly and individually concerned. As regards the legal standing, the interpretation of the ECJ has repeatedly underlined the strictness of this requirement, creating serious constraints on the capacity of undertakings to bring the action for annulment under the scrutiny of the ECJ. However, in the case of the EU Commission's State aid decisions the beneficiary of the aid is considered directly and individually concerned and can therefore bring an action for annulment before the EU Courts.

### **Recovery of State Aid.**

Miladinovic continued addressing the recovery of State aid. She referred to the position taken by the Court of Second Chamber in the case C-148/04,<sup>3</sup> stating that “The withdrawal of unlawful aid by recovery is the logical consequence of the finding that it is unlawful. That recovery for the purpose of re-establishing the previously existing situation cannot, in principle be regarded as disproportionate to the objectives of the Treaty provisions on State aid. By repaying, the recipient forfeits the advantage which it had enjoyed over its competitors on the market, and the situation prior to payment of the aid is restored.” Consequently, the aid to be recovered should not be regarded as a penalty imposed on the Member State concerned. On the contrary, the purpose of the recovery is to re-establish the existing situation prior to the unlawful grant. The sum to be recovered should be equal to the full amount of the aid plus interest. The recovery should take place according to the recovery procedures as governed by Member States’ national laws. It depends on the Member State's national laws through which means recovery orders issued by the Commission are implemented. According to the Procedural Regulation 2015/1589,<sup>4</sup> the recovery of unlawful aid should be implemented within the period of four months upon the entry into force of the Commission’s recovery decision. Also, it is required from the Member State concerned to inform the Commission, within two months, on the procedure chosen to give effect to the recovery decision. Miladinovic explained that the recovery of unlawful aid finds a limitation period of ten years, interrupted every time the Commission initiates a formal in-depth investigation, so that all the aids granted more than 10 years ago cannot be recovered any longer. There are a few exceptions to the general rule that aids must be recovered. One of these is constituted by the protection of the legitimate expectations. This

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<sup>2</sup> <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A12012M%2FTXT>

<sup>3</sup> <http://curia.europa.eu/juris/liste.jsf?language=en&jur=C,T,F&num=C-148/04&td=ALL>

<sup>4</sup> [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2015.248.01.0009.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.248.01.0009.01.ENG)

principle, yet strictly interpreted by the ECJ, refers to the trustworthy expectation arising from prior statements or decisions taken by the Commission, or by the ECJ, on the fact that the measure at issue does not constitute aid or is compatible with the EU internal market.<sup>5</sup>

### **The Role of National Courts in State Aid Enforcement**

Miladinovic provided a brief explanation on the Role of National Courts in State aid enforcement. In 2009, the European Commission issued a notice on the enforcement of State aid law by national courts (hereinafter the Notice), with the aim of providing guidance on how the Commission itself and National Courts should interact and cooperate. The Notice clarifies that it falls under the exclusive competence of the Commission to assess the compatibility of measures with the internal market. Contrarily, the main role of National Courts is to protect the interests of individuals affected by the granting of unlawful aid and to put into effect the Commission's negative decision. According to the Notice, national courts have the power to interpret the notion of State Aid pursuant Article 107 TFEU. Therefore, if the national court detects that the Member State has granted aid without respecting the standstill clause or the notification obligation, the role of the court in such cases is to protect the rights of the individuals affected. These affected parties can enforce their rights by bringing legal action before competent national courts. Depending on the national procedural laws, remedies can include preventing the payment of unlawful aid, recovery of unlawful aid and illegality interest, damages for competitors and other parties concerned as well as other interim measures. As regards the role of the national courts in the implementation of negative Commission decisions ordering recovery, it must be pointed out that besides taking actions for the annulment of a national recovery order, third parties can also claim damages from Member States' authorities for failure to implement the decision. Since the Commission and the Member States have a mutual duty of loyal cooperation as concerns the attainment of the objectives of the EU Treaties, the Commission, for example, offers support to national courts in fulfilling their tasks: National judges may thus ask *inter alia*, for the transmission of information from the Commission, but also seek guidance in the Commission's decision-making practice and request the Commission's opinion on relevant issues concerning the application of the State aid rules.

### **The application of State Aid Law Decisions of the EU Commission and the case-law of the EU Courts**

The European Commission and the European Court of Justice have different roles and competencies whereby the practice of the Commission and its decision making are subject to the review of the ECJ. The latter has the ultimate power to determine whether a proposed measure qualifies as State aid or not. As mentioned, under Article 107 (1) TFEU, in order for a measure to qualify as State aid, it must grant an economic advantage, it must be financed through State resources, it must be selective and to distort or threaten to distort competition affecting trade. In this respect, Szudoczky explained that especially in the field of fiscal aid, the assessment of the selectivity element is the most critical to determine the existence of State aid. The approach taken by the Commission is to establish the existence of selectivity through a three steps analysis. This *modus operandi* was first set out in the 1998 Notice and re-adopted in the 2016 Notice on the notion of State aid. In the 2016 Notice, the Commission pursued the aim of introducing new guidelines for the interpretation of the concept of State aid having regard to the case law of the ECJ developed since the 1998 Notice. In this sense, in the assessment of the selectivity of a tax measure, the

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<sup>5</sup> The Principle of legitimate Expectation within the EU State Aid Rules will be addressed extensively during WORKSHOP 4, "State aid and legitimate expectation: the role of national legislator, tax administration and national courts".

first step must be to identify the reference system and then to verify whether the measure at issue constitutes a derogation from such reference system. Further, according to the judicial practice developed by the ECJ, when a derogation is established, it is necessary to assess whether the derogation itself can be justified on the basis of the nature and general scheme of the system of which the measure is part (so-called justification ground). The Court allows a selective treatment to be justified only on the ground of intrinsic reasons to the tax system. These must be in line with guiding principles necessary for its functioning and effectiveness of the tax system (for example, measures aimed at avoiding double taxation), rejecting, by contrast, any justification based on external policies (for example, measures based on social or economic reasons).

Szudoczky explained that differently from the Commission's 1998 Notice the ECJ, starting from the landmark *Adria-Wien Pipeline* case (C-143/99), the ECJ has regarded the selectivity element from a comparative perspective. It has looked at the situation of the beneficiary of the alleged selective measure in comparison with the respective position of all other undertakings in an objectively comparable factual and legal situation. This is, in fact, a discrimination analysis. In the Court's view, the existence of a discriminatory treatment was in itself sufficient in order for a tax measure to meet the condition of selectivity. A careful analysis shows that the Commission's and Court's apparently different methods to establish selectivity have been merged, as demonstrated by the guidance given in the 2016 Notice on the notion of State aid, where the derogation test and the comparison test are incorporated into one definition. This follows the Court's judgement in the *Paint Graphos* case (C- 78/08 to C-80/08) where the Court stated that "in order to classify a domestic tax measure as 'selective', it is necessary to begin by identifying and examining the common or 'normal' regime applicable in the Member State concerned. It is in relation to this common or 'normal' tax regime that it is necessary, secondly, to assess and determine whether any advantage granted by the tax measure at issue may be selective by demonstrating that the measure derogates from that common regime inasmuch as it differentiates between economic operators who, in light of the objective assigned to the tax system of the Member State concerned, are in a comparable factual and legal situation [...]". As it appears, the objective of the normal tax system, i.e. the reference system, is used by the ECJ as *tertium comparationis* in order to assess whether or not a discriminatory treatment between economic operators exists. In other words, the question whether or not two economic operators are in an objectively comparable legal and factual situation must be assessed in the light of the *objective of the tax system*.

Dr. Szudoczky continued clarifying that the application of the State aid definition in the field of taxation still raises a number of complex conceptual questions that yet have not been answered either by the Commission practice or the ECJ's case law. For example:

- Are advantage and selectivity two separate elements of the State aid concept? Do they involve different enquiries or can they be collapsed to a comparison test?
- How to distinguish selective and general tax measures?
- What if the general tax system is designed in a way that it leads to certain undertakings being favoured without any derogation?
- How to identify the reference system in the context of abstract tax rules?

Theoretically, with regard to the first point, the two concepts of advantage and selectivity should be taken into account as two separate conditions. The existence of an economic advantage may only be determined

in comparison with the tax system generally applicable to all undertakings. Contrarily, the selectivity of a measure should be assessed by identifying a derogation from the reference system leading up to unequal discriminatory treatments.

However, from a practical standpoint, both elements require the identification of the normal taxation and a derogation from that, whose assessment would necessarily involve the comparison between undertakings who are subject to the normal taxation and those enabled of benefiting from the derogatory measure. Interestingly, by looking at the case law of the ECJ and the Commission's decisions in the Apple, Fiat and Starbucks cases, the requirements as to the economic advantage and selectivity were practically merged into a selective advantage test. This test is, in effect, a general discrimination analysis which examines the question of whether the differential treatment relates to situations which are indeed comparable in the light of the objective of the reference system. Under this approach, any sort of discriminatory treatment between economic operators would amount to the granting of aid, broadening excessively the State aid concept. Likewise, considering any sort of derogation from the reference system as a selective advantage without any distinction between the concept of advantage and selectivity would bring to consider any advantage granted within the tax system as State aid, although it may be potentially accessible to all undertakings on an equal footing.

Dr Szudoczky then addressed the question whether the establishment of a derogation from the reference system which boils down to a discriminatory treatment is sufficient for a finding of selectivity through the two very important cases, *Word Duty-Free* and *Banco Santander* (C-20/15 P and C-21/15 P). The cases concerned a Spanish measure granting goodwill amortisation only in cases of acquisition of foreign shareholdings. Such amortisations costs were not granted if the parent company had acquired a domestic shareholding. Thus, Spanish companies were incentivised to acquire foreign shareholdings essentially, subsidizing export of capital. The main question was whether the fact that goodwill amortization was allowed only in cases of acquisition of foreign shareholdings constituted a selective advantage for certain companies, i.e. companies investing in foreign shareholdings, considering that any company could make such an investment and therefore the advantage does not seem to be constrained to a specific category of taxpayers.

Essentially, in these cases, the issue as to how to distinguish general and selective tax measure was the central question. The controversy surrounding this issue is well demonstrated by the opposing positions taken by the General Court and the ECJ on this matter. In particular, in line with the General Court's attitude that tends to adopt a more restrictive interpretation of the State aid rules, the General Court held that an exception from the reference framework is not sufficient to make a tax measure selective, particularly when a tax measure is potentially accessible to all undertakings. Only if the measure benefits a *particular category of undertakings which can be differentiated from the rest of the undertakings based on specific characteristics*, the measure can be considered selective. To the contrary, the ECJ decided that Court's case law merely requires that a measure which derogates from the ordinary tax system leads to discrimination. In other words, no supplementary condition exists which would require the identification of a particular category of undertakings which are distinguished by specific characteristics. These opposing views could be seen as a sign of an internal juridical battle between the two courts which featured in a series of cases where the General Court annulled the Commission's decisions qualifying certain measures as State aid while the ECJ overturned the General Court's decision once again and sided with the Commission's original decisions.

In conclusion, in this specific case it was possible to identify a derogation from the reference system precisely because foreign shareholders were treated differently from domestic ones. The only test that had been applied was the discrimination test. This case confirms the very broad scope of the State aid rules and shows the ECJ's resistance to any attempt which seeks to narrow such scope by introducing additional conditions that are not inherent in the concept of State aid as interpreted throughout the ECJ's jurisprudence.

Another case which is important for the assessment of selectivity of fiscal measures is the Gibraltar case (C-106/09 P and C-107/09 P). At issue was the general tax system proposed to be introduced in Gibraltar which consisted of a payroll tax and a property tax according to which the tax liability could not be higher than 15% of the profits. Such system was designed in a way that due to its inherent characteristics it benefitted offshore companies that typically have no employees and business premises in Gibraltar and thus can escape taxation in Gibraltar altogether. The General Court held that the proposed system were to be the general tax system in Gibraltar and the Commission erred in qualifying such system as State aid, as the Commission was not able to identify a derogation from the general system which would lead to a selective advantage to certain enterprises. Therefore, it annulled the Commission's decision. However, the ECJ disagreed with the General Court and stated that "...the criteria forming the basis of assessment which are adopted by a tax system ... [are] such as to characterise the recipient undertakings, by virtue of the properties which are specific to them, as a privileged category" which is sufficient for qualifying the proposed system as selective. Thus, in certain cases, the presence of a derogation from a general system is not necessary for a measure to constitute State aid. This is another step towards the broadening of the concept of State aid. Thereafter, Mirna S. Screpante, visiting researcher at the Institute for Austrian and International Tax Law, WU, Vienna, discussed a case where the issue was distinguishing between direct and indirect beneficiaries of an aid (Case T-445/05). In the case, it was held that tax incentives for investment in collective funds specialising in SMEs are not State aid for the investors (direct beneficiary) but are State aid for the collective funds (SIVs), their fund managers and the firms in which the funds invested (indirect beneficiary).

Finally, Screpante introduced the most recent developments in the Commission's fiscal State aid practice, that is, the scrutiny of individual tax rulings and advance pricing agreements under the State aid rules. After an overview of the cases currently pending, she described the McDonald's case more in detail. In this case, the Commission examines a ruling granted by the Luxembourg tax administration to a Luxembourg member of the McDonald's group. In the ruling the tax administration agreed to grant an exemption on income which has not been taxed in the US pursuant to the Luxembourg-US tax treaty. The case shows that the ever-expanding scope of the State aid rules can possibly reach advantages resulting from mismatches between different tax systems. Whilst this is the position taken by the Commission, the final word on these cases by the ECJ still awaits for a few years.

### **The Arm's Length Principle normative references**

Claire (Xue) Peng, research associate at WU Transfer Pricing Centre, Institute for Austrian and International Tax Law of Vienna University of Economics and Business, addressed the Arm's Length Principle's legal framework providing an insight on the origin of Transfer Pricing Rules and its historical evolution. From an international perspective, Article 9, OECD MC is recognised as the most authoritative provision for the application of the Arm's Length Principle. Article 9 (1) OECD MC states as follows:

“Where:



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

The same person participates 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 these conditions, have accrued to one of the enterprises, but, by reasons of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”.

The OECD commentary does not represent a binding instrument for Government. Transfer pricing adjustments may only be grounded on Member States’ respective Domestic Laws. Indeed, it is on the basis of domestic transfer pricing provisions that tax authorities are allowed to adjust the transfer pricing and to re-determine the allocation of taxable base. Also, domestic laws may provide the legislative references for secondary adjustments. Secondary adjustment aims at aligning the tax account and statutory accounts, making them consistent with each other. Although secondary adjustment rules are present in a number of jurisdiction, under the OECD Model Tax Convention, tax authorities are not required to implement it.

Peng continued underlying that national transfer pricing legislation represents the *condition sine qua non* for giving effect to the Arm’s Length Principle regardless for the denomination of the existing domestic rules. Therefore, the analysis of the different national Transfer Pricing standards is of particular importance as, ultimately, they have a strong influence not only on the practice but also for the avoidance of double taxation.

In this respect, the OECD Transfer Pricing Guidelines provide guidance for the interpretation of Article 9 OECD MC thus for the application of the Arm’s length principle. Despite their non-mandatory nature, these guidelines represent an effective tool for overcoming regulatory loopholes created by differences between respective domestic transfer pricing legislations.

Peng concluded clarifying the difference between the OECD transfer pricing guidelines and the UN manual. Equal to the OECD transfer pricing guidelines, the UN transfer pricing manual provides guidance for the application of the Arm’s length principle. The two instrument may be considered to be in line with each other. However, the ladder was developed by broad a group a practitioner in absence of a shared agreement upon from States’ Tax Administration. Therefore, from a certain perspective, comparing the two instruments, the UN Manual has slightly less binding authority.

## **Introduction to Transfer Pricing**

Dr. Raffaele Petrucci, Managing Director at WU Transfer Pricing Centre, Institute for Austrian and International Tax Law of Vienna University of Economics and Business, addressed the function of transfer pricing, the different approaches underlying its application and the arm’s length principle.

He highlighted that most of the state aid cases currently under the scrutiny of the European Commission and the ECJ, show that transfer pricing may be considered as one of the most relevant topics concerning multinational enterprises. He defined transfer pricing as “the price charged by individual entities for goods or services supplied to one another in multi-department, multi-office, or multinational firms”.

Transfer pricing transactions assume relevance in all those situations where a company is engaged in the transfer of goods or services to another company of the same group, creating the need (for accounting purposes) to determine the prices charged for those transactions. The clarified that transfer pricing is not only a tax issue, though it may become a tax issue when intra-group entities are located in different countries, and each of these Countries applies a different tax rate on corporate profits. On all these cases, issues may arise from the possibility for multinational groups, to alter the value of their transactions (between related companies) allocating higher costs to the group company in the country with the higher tax rate and higher revenue to the group company located in the country with the lowest corporate income tax rate. Though in simple terms, this may describe the mechanism through which it is possible, for multinational enterprises, to shift profits from one country to another, as to why the role of Tax Laws and Transfer Pricing rules must be to counter the shifting of profits to low-tax jurisdictions and the consequential erosion of taxable bases.

Dr. Petruzzi provided an example referred to the hypothesis of a U.S. based Corporation engaged in the production of phones, operating through its manufacturer and distributor located accordingly in China and Austria. Assuming that the Chinese manufacturer purchases the component needed for the production of phones from the Chinese market for the price of €20, and after having assembled the phones it sales the final products to the distributor located in Austria for the price of €100, the first figure would be that the profits for the Chinese manufacturer are equal to €80. The value creation chain would then continue by the sale of final products in the Austrian market by the Austrian distributor for the price of €400, realising profits equal to €300. In this scenario, the overall group revenue is equal to €380. According to Dr. Petruzzi, the fact that no low tax jurisdiction is involved clearly shows that transfer pricing is not necessarily an issue related to countries providing favourable tax rates.

He then continued explaining that on an international level, for the analysis of transactions between related companies, there are different methods to be adopted. These are respectively, the Arm's Length Principle and the Global Formulary Apportionment (CCCTB). The latter, however, still subject to a proposal by the European Commission.

Dr. Petruzzi underlined that implementing the Global Formulary Apportionment method on the previous hypothetical example would have led to a substantial different result. Indeed, the group revenue of €380 should be distributed among the various group entities based on a pre-defined formula. In Europe, according to the CCCTB proposal, the parameter to be taken into account should be revenues, assets and human capital. Each parameter would account for 1/3 whereby the total group revenue should be allocated based on where the revenue is generated and the substantial assets and human capital are located. Petruzzi emphasised that the adoption of a pre-defined formula to allocate the creation of income may inadequately reflect the true value creation chain. Hence, one of the main issues arising from the implementation of the Global Formulary Apportionment would be that government shall agree in advance on the parameters to apply, creating difficulties in reaching general consensus for the splitting of the taxable base, thus on the formula to be used.

Dr. Petruzzi continued illustrating that by now, as suggested by the OECD, the internationally adopted standard for the allocation of taxable income between associated enterprises is the at arm's length principle. In this respect, article 9 (1) OECD MC provides as follows:

“Where:

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

The same person participates 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 these conditions, have accrued to one of the enterprises, but, by reasons of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”.

Considering the main advantages stemming from the adoption of an at arm’s length principle, this would bring equal treatment between related and unrelated transaction. The use of an at arm’s length principle may also allow commercial flexibility with respect to specific business circumstances, for example, group synergies. In conclusion, it represents an effective tool for restraining tax avoidance and/or tax planning, for the avoidance of double taxation and for guaranteeing a fair and balanced allocation of taxing rights between different States.

Petruzzi provided a practical clarification applying the at arm’s length principle to the preceding example. Contrarily to what seen under the application of the Global Formulary Apportionment, by applying the arm’s length principle, the overall activity of the corporate group must be segmented transaction by transaction. Also, the Chinese Tax Administration would be given the possibility to adjust the price charged by the Austrian distributor from €100 to €200. This adjustment, made in order to reflect the Arm’s Length price, would be allowed not only under Chinese domestic legislation, provided that the Arm’s Length Principle is domestically regulated, but also under Article 9 OECD MC. Therefore, following the Chinese tax administration adjustment, the Chinese manufacturer taxable base increases from €100 to €180. Accordingly, and in principle, the Austrian taxable base remains consistent at €300 because, as seen, the Austrian tax administration is not obliged whatsoever to level out the Austrian distributor taxable base on the adjustment made by the Chinese tax administration. In line with this, the overall group taxable base would rise from €380 to €480, creating a hypothesis of economic double taxation on €100.

Within this context, Petruzzi underlined that the objective of the arm’s length principle are the profits arising from transactions between related parties rather than the mere price of the transactions. Indeed, setting the focus on the overall profits allow tax Administration to go further beyond the mere price terms and to look at the entire structure of the intra-group relation. Hence, if the substance of a certain transaction does not properly reflect its real nature, transfer pricing rules give Tax administrations the tools for re-categorising the entire transaction.

Dr. Petruzzi explained that the issue of economic double taxation is dealt with by Article 9 and 25 OECD MC. Also, (economic) double taxation is the situation that double tax treaties aim at preventing.

Continuing to refer to the aforementioned case, Dr. Petruzzi underlined that once an adjustment is made by the Chinese tax administration, Article 9 (2) OECD MC gives the Austrian tax administration the possibility to adjust its Austrian distributor taxable base accordingly. Though, as anticipated, the wording used by the article, does not impose any binding obligations. Indeed, Article 9(2) OECD provides as follow: “where a Contracting State includes in the profits of an enterprise of that State – and taxes

accordingly – profits which an enterprise of the other Contracting state has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other”.

Dr. Petruzzi stressed the attention on the wording “... State shall make an appropriate adjustment ...” underlying that it clearly shows the non-binding nature of the provision. Therefore, in the case where two tax authorities do not agree on the arm’s length price of a transaction, creating economic double taxation, they should, eventually, resort to a mutual agreement procedure (MAP).

This is precisely because, under Article 25(5) OECD MC, the OECD has introduced an arbitration clause procedure in order to improve the resolution of tax treaty disputes. Should be noted that, however, the absence of an arbitration clause in yet a large number of bilateral tax treaties, leaves room to cases of unavoidable double economic taxation.

Dr. Petruzzi concluded observing that it is also on the ground of these issues that individual tax rulings and advanced pricing agreement assume particular relevance in the field of transfer pricing. Indeed, these instruments have the function of providing certainty for taxpayers on the determination of the arm’s length value of a transaction before entering into a transaction with a related party. Nevertheless, a veil of uncertainty will always be destined to remain due to intrinsic difficulties to determine, beyond any reasonable doubt, what is the arm’s length nature of a transaction.

### **The application of Transfer Pricing in the context of State aid law**

The last session of the seminar was opened by Raphael Holzinger, research associate at the Institute for Austrian and International Tax Law, Transfer Pricing Centre at Vienna University, Vienna. He provided a general introduction on the conceptual basis linking the two concepts of State aid and transfer pricing. Concepts which combination raises significant conceptual issues yet to be answered. According to Holzinger, in the analysis of state and transfer pricing rules, the first aspects to be taken into account must be the normative frameworks of reference. According to the general interpretation of the provision under Article 107 TFEU, the reference framework for the application of at the arm’s length principle must be the domestic law of the respective Member State. By contrast, the normative reference for the interpretation and application of Article 9 OECD MC is constituted by the OECD Transfer Pricing Guidelines. The next controversial equation addressed was the compliance with the principle of equal treatment in fiscal matter from both, competition law and allocation of taxing jurisdiction perspective. These two aspects may be considered as being opposite sides of the same coin. Indeed, under Article 107 TFEU it is necessary to assess whether transfer pricing transactions lead to a market result, e.g., if the value accorded to controlled transactions distorts or threatens to distort competition. Meanwhile, the application of Article 9 OECD MC raises the question on whether the factual and functional aspect of the transaction were fully considered when the transaction was priced, hence if the value of the transaction is consistent with the Arm’s Length value.



## The Fiat Case

Holzinger continued his intervention underlying how the two issues of transfer pricing and State aid are indeed deeply intertwined by referring to the two very important cases of FIAT Finance and Trade and Starbucks.

He explained that the European Commission investigation on FIAT Finance and Trade (FFT), started on the 21st of February 2014 with a notification from the DG Competition to Luxemburg. Prior to this formal notification, both, Luxemburg and FFT were asked to provide the Commission with information concerning certain advanced pricing agreement that Luxembourg authorities granted to FFT. DG Comp, after having scrutinised all the relevant information received decided to initiate a formal in-depth investigation procedure. On 21st October 2015, the Commission issued its negative decision ordering Luxemburg for the recovery of alleged unlawful aid granted to FFT. In its decision, the DG Comp identified two main elements not being in line with Article 107 TFEU. Due a number of economically unjustified assumptions and downtrend adjustments, the capital base approximated by the tax ruling was considered to be much lower than the company actual capital. The remuneration estimated for tax purposes, for the already insufficient capital, was also considered to be too low. Therefore, the Commission concluded that Fiat obtained illegal tax advantages from Luxemburg.

In order to address the rationale beyond the Commission decision, Holzinger illustrated the shareholding structure of the Fiat Group Companies. FF SPA, the ultimate Italian parent company of the entire FIAT group, had a 40% participation in the Luxemburgish FFT. Also, FF SPA had an indirect participation in FFT through another Italian company, FFS. For the DG Competition the two Italian Companies were not relevant from a competition law perspective. However, FFT had two 100% subsidiaries, accordingly, Fiat Finance North America (FFNA) and Fiat Finance Canada (FFC). The overall functional analysis of FFT showed that it carried out financing activities for the entire FIAT Group as a Treasury Service Company. Interestingly, these financing activities were capitalised through loans from the two associated enterprises, FFNA and FFC, via bank credits and by recurring to the free financial market. These capital instruments as the entire liquidity so obtained were then transferred to the EU subsidiaries as well as to the Italian FF SPA via different loans.

Holzinger continued explaining that from a prima vista perspective, the transfer pricing transactions concluded by the Luxemburgish FFT, complied with the Luxemburg transfer pricing legislation. Indeed, according to the criteria outlined as to the transfer pricing Circular MIR 162/2 (applied in the present case and on whose basis FFT obtained the APA) the substance requirement, equity and risk requirements and the support of arm's length compensation were all fulfilled.

The Commission's investigation activity focused on the scrutiny of the advanced pricing agreement between Luxemburg and Fiat. According to the Commission view, in order to deem the existence of an unlawful aid, it had to further verify whether the measure conferred any selective advantage to FTT (compared to other undertakings in a comparable factual and legal situation). On this basis, the in-depth investigation addressed seven different points that needed to be further analysed. As anticipated, Fiat Finance and Trade taxable base was considered to be inconsistent with respect to its estimation and remuneration of capitals. Indeed, the APA between Luxemburg and FFT provided for a fixed tax base subject to a variation of about 10% regardless of any significant variation in the activities actually performed. The second point at stake was the choice for the transactional net margin methods (TNMM).

In a nutshell, the adoption of the TNMM implied the comparison of the net margin profits either applied on costs, capitals or revenues. In this case, the Commission's scrutiny mainly focused on the appropriateness of the capital, although from a methodology perspective, the TNMM was found to be in line with the arm's length price. The next issue, besides the choice of the applicable transfer pricing method, was the analysis of the appropriateness of the amount of capital to be remunerated. In this regard, the DG Comp held that the determination of capital was not based on criteria reflecting the factual and functional situation, hence, was not considered in line with the arm's length principle nor Article 107 TFEU. Concerning the comparability analysis, the DG Comp found that among the sixty-six companies derived from the benchmarking study, the most of them should not have been taken into consideration since not comparable whatsoever. Indeed, among others, two central banks were used as a term of comparison. Holzinger continued explaining that two others problematic and at the same time interesting aspects emerging following the Commission's investigation activity were related to the inappropriate deduction from accounting capital and the level of required return.

Holzinger concluded his analysis of the Fiat Case summing up all the major issues at stake. Besides the alleged inconsistency of the capital and its remuneration, it emerged that the Commission showed a preference for application of the CUP method over the TNMM despite having considered the latter in line with the arm's length principle as requested under Article 107 TFEU. Also, the DG Comp raised doubts regarding the choice of the comparable, holding that the comparison should have rather been made against stand-alone companies on the basis of a purely domestic perspective.

### **The Starbucks Case**

The Starbucks case was dealt with by Alexandra Miladinovic. The Case started in July 2014 when the Commission addressed the Dutch tax authorities with a request for information regarding all tax rulings related to Starbucks. Starbucks is a coffee company engaged in the market retail of speciality coffee. The company group is composed of Starbucks corporations and several controlled companies. Starbucks' headquarter is based in Seattle, US, and the group operates on a worldwide basis. Starbucks manufacturing is a group subsidiary incorporated in the Netherlands which operates as a roasting facility. It roasts coffee beans and sells the roasted coffee to coffee shops and customers. Also, Starbucks manufacturing licensed coffee roasted related IP from ALKI LP beyond payment of royalties. Starbucks Coffee is the head-quarter of the Starbucks group for Europe; it is also incorporated in the Netherlands. It licences trademarks, technology and know-how for ALKI LP.

In 2008, Starbucks Manufacturing concluded an APA, binding for 10 years, with the Dutch tax administration. Under this APA, Starbucks Manufacturing was qualified as a low-risk manufacturer operating between a 9-10% on a Cost-Plus basis. The parties agreed on the amount of the remuneration for the payment of royalties to ALKI. It was established that Starbucks Manufacturing should have paid a mark-up of 9-12% on the relevant tax base. Hence, at the end of each year, ALKI LP should have determined the difference between operating profits before royalty expenses and the 9-12% mark-up on operating expenses in order to match the range approved by the APA.

Miladinovic explained that the APA was concluded on the basis of Article 8b (1) of the Dutch Corporate Tax Act. This provision lays down the arm's length principle as provided with by the Dutch domestic law. The Dutch normative framework also provides for a transfer pricing Decree of 2001 serving as guidance for the Dutch tax administration on how to interpret the OECD at arm's length principle.

Starbucks Manufactory's taxable profits in the Netherlands, determined on the basis of the aforementioned APA, were reduced according to the royalties paid to ALKI LP. Interestingly, in the profits and loss account, as presented in its final statement, Starbucks Manufacturing also indicated other expenses related to the royalty payment agreement with ALKI LP. The taxable profits were calculated at approximately 9-10% of the operating expenses, and the excess profits beyond the 9-12% were paid by Starbucks manufactory to ALKI LP for the Coffee roasting related IP.

The EU Commission held that the APA did not comply with the (OECD) at arm's length standard for the following reasons:

- Starbuck Manufacturing was not considered to be a low-risk manufacturer precisely because it carried out relevant inventory risks. Indeed, the founding of the Commission showed that it had inventory risks in its balance sheet. Also, in 2011 it booked immature losses.
- The Cost-Plus basis should have included the prices for the green coffee beans. Therefore, the comparability adjustment made was inappropriate and the value for the royalty payment was not related to the value of the IP.
- Due to the use of the TNMM in the transfer pricing analysis, in reality, the royalty payment only corresponded to Starbucks Manufacturing's residual profits. Hence, any profit recorded by Starbucks Manufacturing above the 9-12% of operating expenses was transformed in a tax-deductible royalty.

Miladinovic concluded explaining that, within its investigation activity on the alleged irregularities concerning the APA, the EU Commission had to verify whether the four conditions set forth in Article 107 TFEU were met. The fact that the APA was concluded with the Dutch authorities clearly showed that the requirement as to the State intervention was met. Also, the conclusion of the APA, deviating from the general CIT normally applicable, resulted in a significant lowering of Starbucks tax liability in the Netherlands, thus, a loss of State resources. Furthermore, by analysing the Starbucks Group global activities, the Commission believed that the measure granted had potential negative effects on the system of competition. As regards the assessment of the existence of a selective advantage, the Commission started with the determination of the reference system. According to the Commission, this had to be identified in the general Dutch Income Tax system. The Commission stated that, in principle, the general system is composed and consists of the rules that apply to all undertakings falling under its scope on the basis of objective criteria. Therefore, the scope of the Dutch CIT was identified in taxing the profits of all undertakings subject to taxation in the Netherlands without any sort of discrimination between them.

In the present case, for the purpose of Article 107 TFEU, the Commission believed that the APA conferred a selective advantage to Starbucks by providing for an unjustified reduction of its tax liability. The Commission explained that the methodological choice underlying the transfer pricing report was inappropriate. The adoption of the TNMM, the choice for the operating expenses as profit level indicators for the use of the TNMM, and the application of a working capital adjustment to address differences between Starbucks Manufacturing and the chosen comparable for the estimation of the at arm's length price were all wrong. The Commission added that the transfer pricing report failed to provide sufficient information on a comparable uncontrolled transaction against the roast IP agreement between Starbucks Manufacturing and ALKI LP. Consequently, it was impossible to establish that the agreement complied with the at arm's length price. Furthermore, the Commission held that given the impossibility to estimate the at arm's length price for the royalty payment to AKLI LP, it should have been equal to zero.



In conclusion, the Commission decided in order for the unlawfulness of the measure, therefore, its recovery was ordered. According to the procedural regulation, the recovery procedure had to be implemented by the Netherlands. However, in case Starbucks Manufacturing should not have been in the position to repay the full amount in concern, the Netherlands had to address the request to Starbucks Corporation as the entity controlling the entire group.

On December 23rd, 2015, the Netherlands initiated an action for annulment against the Commission decision based on five main complaints:

- The APA was not selective in nature so that the Commission did not adequately and separately demonstrate that the selectivity element was fulfilled. Precisely, the Commission erroneously considered the general Dutch tax system as the reference system. According to the Dutch tax administration, the reference system should have been the Dutch Article 8 b CIT.
- The incorrect assessment of the advantage by reference to a EU at arm`s length principle. The applicant indeed disputed the existence of an EU at arm`s length principle
- The inexistence of any advantage because of the selection of the TNMM as settlement price methodology
- The inexistence of any advantage resulting from the manner of applying the TNMM as the application of another method would not have led to the determination of higher profits
- The applicant, regarding the formal plea of law, alleged the breach of the duty to exercise due care.