THE EUROPEAN COMMISSION'S RECENT STATE AID INVESTIGATIONS OF TRANSFER PRICING RULINGS

U.S. DEPARTMENT OF THE TREASURY WHITE PAPER

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EXECUTIVE SUMMARY

The U.S. Department of the Treasury ("U.S. Treasury Department") shares the European Commission's ("Commission") concern with tax avoidance by multinational firms. The international community, including the European Union ("EU") and its Member States, has long recognized the need to address this issue multilaterally. For more than two decades, the U.S. Treasury Department has worked closely as part of the international community to achieve a collective solution to this global problem.

Beginning in June 2014, the Commission announced that certain transfer pricing rulings given by Member States to particular taxpayers may have violated the EU's restriction on State aid. These investigations, if continued, have considerable implications for the United States—for the U.S. government directly and for U.S. companies—in the form of potential lost tax revenue and increased barriers to cross-border investment. Critically, these investigations also undermine the multilateral progress made towards reducing tax avoidance.

In light of these consequences, U.S. Secretary of the Treasury Jacob J. Lew sent a letter on February 11, 2016, to Commission President Jean-Claude Juncker describing the U.S. Treasury Department's principal concerns with the Commission's recent State aid investigations. This White Paper provides additional detail regarding Secretary Lew's concerns, focusing primarily on the following issues:

- The Commission's Approach Is New and Departs from Prior EU Case Law and Commission Decisions. The Commission has advanced several previously unarticulated theories as to why its Member States' generally available tax rulings may constitute impermissible State aid in particular cases. Such a change in course, which has required the Commission to second-guess Member State income tax determinations, was an unforeseeable departure from the status quo.

- The Commission Should Not Seek Retroactive Recoveries Under Its New Approach. The Commission is seeking to recover amounts related to tax years prior to the announcement of this new approach—in effect seeking retroactive recoveries. Because the Commission's approach departs from prior practice, it should not be applied retroactively. Indeed, it would be inconsistent with EU legal principles to do so. Moreover, imposing retroactive recoveries would undermine the G20's efforts to improve tax certainty and set an undesirable precedent for tax authorities in other countries.

- The Commission's New Approach Is Inconsistent with International Norms and Undermines the International Tax System. The OECD Transfer Pricing Guidelines ("OECD TP Guidelines") are widely used by tax authorities to ensure consistent application of the "arm's length principle," which generally governs transfer pricing determinations. Rather than adhere to the OECD TP Guidelines, the Commission asserts it is employing a different arm's length principle that is derived from EU treaty law. The Commission's actions undermine the international consensus on transfer pricing standards, call into question the ability of Member States to honor their bilateral tax treaties, and undermine the progress made under the OECD/G20 Base Erosion and Profit Shifting ("BEPS") project.

I. Introduction

The Treaty on the Functioning of the European Union ("TFEU") provides that "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."[1] The State aid rules "ensure that the functioning of [the] internal market is not distorted by anticompetitive behavior . . . favouring some actors to the detriment of others."[2]

Recently, the Commission has initiated a series of State aid investigations primarily involving U.S.-headquartered companies that had obtained tax rulings from Member States. As context for this paper's broader observations, this Part reviews the Commission's ongoing investigations of these companies and highlights the implications these investigations have for the United States.

A. Current Investigations

As with Member State tax determinations generally, determinations with respect to prices related parties charge each other for purposes of determining income tax liability (also known as transfer pricing arrangements) have historically been the province of the individual Member States. Starting in June 2014, however, the Commission announced that certain transfer pricing rulings given by Member States to particular taxpayers may have violated the EU's restriction on State aid. To date, the Commission has initiated State aid investigations against Apple, Starbucks, Fiat (now Fiat Chrysler Automobiles), and Amazon (collectively, the "State Aid Cases").[3] A summary of the allegations and status of each case follows:

- Apple: On June 11, 2014, the Commission initiated an investigation of advance pricing arrangements provided by the Irish tax authorities regarding the attribution of profits to an Irish branch of an Irish company that, under Irish law, was treated as non-resident for Irish tax purposes because it was not managed and controlled in Ireland. The

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[1] Consolidated Version of the Treaty on the Functioning of the European Union art. 107(1), 2016 O.J. C 202/47.

[2] Commission Communication COM/2012/209, *EU State Aid Modernisation (SAM)*, ¶ 2 (May 8, 2012).

[3] In addition, the Commission has ruled that Belgium's entire "excess profits tax ruling system" constituted State aid. *Excess profit exemption state aid scheme implemented by Belgium*, Commission Decision COMP/SA.37667 (Jan. 11, 2016) [hereinafter *Belgian Excess Profit Scheme Decision*]. On December 3, 2015, the Commission also initiated an investigation of tax rulings provided to a McDonalds's affiliate in Luxembourg that exempted income of the affiliate that was related to a permanent establishment in the United States. The Commission has not issued a final decision; however, its preliminary view is that the rulings constitute State aid. *Alleged aid to McDonald's*, Commission Decision COMP/SA.38945, 2016 O.J. C 258/11. The McDonald's investigation does not relate to transfer pricing and is not the focus of this paper. However, the U.S. Treasury Department continues to follow that proceeding and consider its implications for the United States.

Commission has not issued a final decision; however, its preliminary view is that the arrangements constitute State aid.[4]

- Starbucks: On June 11, 2014, the Commission initiated an investigation of advance pricing arrangements provided by Dutch tax authorities relating to the transfer price of royalties paid by a Starbucks affiliate in Netherlands to its UK affiliate, as well as the prices paid by a Dutch manufacturing affiliate to a Swiss affiliate for roasting coffee beans. The Commission has issued a final decision that the arrangements constitute State aid.[5] The decision is on appeal to the EU General Court.[6]

- Fiat: On June 11, 2014, the Commission initiated an investigation of an advance pricing arrangement provided by Luxembourg tax authorities to a Fiat financing company based in Luxembourg. The Commission has issued a final decision that the arrangements constitute State aid.[7] The decision is on appeal to the EU General Court.[8]

- Amazon: On October 7, 2014, the Commission initiated an investigation of advance pricing arrangements provided by Luxembourg tax authorities relating to the transfer price of royalties paid by an Amazon Luxembourg affiliate. The Commission has not issued a final decision; however, its preliminary view is that the arrangements constitute State aid.[9]

B. Implications for the United States

The Commission's State aid investigations, if continued on their current trajectory, have considerable implications for the United States—both for the U.S. government and its companies. In particular:

- The Commission's actions undermine the United States' efforts in developing transfer pricing norms and implementing the OECD/G20 BEPS project. The Commission's

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[4] *Alleged aid to Apple*, Commission Decision COMP/SA.38373, 2014 O.J. C 369/22 [hereinafter *Apple Opening Decision*]. Under Irish law, an Irish non-resident company, just like any other non-resident company, would have been subject to tax only on the income attributable to activities in Ireland.

[5] *State aid implemented by the Netherlands to Starbucks*, Commission Decision COMP/SA.38374 (Oct. 21, 2015) [hereinafter *Starbucks Decision*].

[6] *Netherlands v. Commission*, Case T-760/15, 2016 O.J. C 59/50 (action brought on Dec. 23, 2015 by the Netherlands seeking to annul *Starbucks Decision*).

[7] *State aid which Luxembourg granted to Fiat*, Commission Decision COMP/SA.38375 (Oct. 21, 2015) [hereinafter *Fiat Decision*].

[8] *Luxembourg v. Commission*, Case T-755/15, 2016 O.J. C 59/48 (action brought on Dec. 30, 2015 by Luxembourg seeking to annul *Fiat Decision*); *Fiat Chrysler Finance Europe v. Commission*, Case T-759/15, 2016 O.J. C 59/49 (action brought on Dec. 29, 2015 by Fiat Chrysler Finance seeking to annul *Fiat Decision*).

[9] *Alleged aid to Amazon*, Commission Decision COMP/SA.38944, 2015 O.J. C 44/13 [hereinafter *Amazon Opening Decision*].

actions also call into question the ability of Member States to honor their bilateral tax treaties with the United States.

- There is the possibility that any repayments ordered by the Commission will be considered foreign income taxes that are creditable against U.S. taxes owed by the companies in the United States. If so, the companies' U.S. tax liability would be reduced dollar for dollar by these recoveries when their offshore earnings are repatriated or treated as repatriated as part of possible U.S. tax reform. To the extent that such foreign taxes are imposed on income that should not have been attributable to the relevant Member State, that outcome is deeply troubling, as it would effectively constitute a transfer of revenue to the EU from the U.S. government and its taxpayers.

- Although currently there are only three cases involving transfer pricing arrangements obtained by U.S.-headquartered companies, the Commission has suggested that it is still evaluating other tax rulings and may initiate more cases.[10] A substantial number of additional cases against U.S. companies may lead to a growing chilling effect on U.S.-EU cross-border investment.

- Adopting new enforcement regimes with retroactive effect will hinder companies' ability to assess risks and plan for the future, and sets an unwelcome precedent for tax authorities around the world to take similar retroactive actions that could affect U.S. and EU companies alike. It also undermines the G20 agenda to improve tax certainty.

The U.S. Congress has made similar assessments regarding the effect the Commission's investigations may have on U.S. interests. In a January 15, 2016, letter to Secretary Lew, the Chairman, Ranking Member, and other members of the U.S. Senate Committee on Finance stated that the "United States has a stake in these cases and has serious concerns about their fairness and potential impact on the U.S. fisc," and that "these investigations raise serious questions about our ability to rely on bilateral tax treaties negotiated with EU Member States."[11] In a subsequent letter on May 23, 2016, the Senators added that their "concerns are driven not only by the initial cases, but also by the precedent they will create and their long-term implications."[12]

In light of these implications for the United States, the U.S. Treasury Department has expressed strong concerns with the Commission's approach in the State Aid Cases. On February 11, 2016, in a public letter to Commission President Jean-Claude Juncker, U.S. Secretary of the

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[10] *See* Mindy Herzfeld, *How BEPS Brought On The State Aid Investigations*, Tax Notes International, June 6, 2016.

[11] Letter from U.S. Senate Committee on Finance to Jacob J. Lew, U.S. Secretary of the Treasury (Jan. 15, 2016), http://www.finance.senate.gov/imo/media/doc/Finance%20Committee%20Members%20Push%20for%20Fairness%20in%20EU%20State%20Aid%20Investigations.pdf.

[12] Letter from U.S. Senate Committee on Finance to Jacob J. Lew, U.S. Secretary of the Treasury (May 23, 2016), http://www.finance.senate.gov/imo/media/doc/Hatch,%20Wyden,%20Portman,%20Schumer%20Continue%20Push%20for%20Fairness%20in%20EU%20State%20Aid%20Investigations.pdf.

Treasury Jacob J. Lew explained that the Commission's "sweeping interpretation" of State aid doctrine "threatens to undermine" the progress made by the international community "to curtail the erosion of our respective corporate tax bases" and described four principal concerns. First, the Commission has "sought to impose penalties retroactively based on a new and expansive interpretation of state aid rules." Second, the investigations appear "to be targeting U.S. companies disproportionately." Third, the new enforcement theory "appears to target, in at least several of its investigations, income that Member States have no right to tax under well-established international tax standards." Fourth, the Commission's investigations "could undermine U.S. tax treaties with EU Member States."[13]

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The remainder of this paper expands upon the concerns raised in Secretary Lew's February 2016 letter. Part II explains that under previously understood standards for evaluating State aid, companies were not on notice that the Commission might take a new approach when applying State aid law to individual transfer pricing rulings. Part III states that the Commission's choice to seek retroactive recoveries under its newly adopted approach is inconsistent with EU legal principles and that the Commission should avoid applying its new approach retroactively, which would also undermine G20 efforts to improve tax certainty. Part IV explains why, if continued, the Commission's approach will undermine the international consensus on transfer pricing standards, call into question Member States' ability to comply with existing bilateral tax treaties, and undermine the progress made under the OECD/G20 BEPS project that the Commission endorsed as a G20 member.[14]

II. The Commission's Approach Is New and Departs from Prior EU Case Law and Commission Decisions

The European Court of Justice ("ECJ") has held that State aid exists when a national measure: (1) is financed by the State or through State resources, (2) provides an advantage for an

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[13] Letter from Jacob J. Lew, U.S. Secretary of the Treasury, to Jean-Claude Juncker, President of the European Commission (Feb. 11, 2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Letter-State-Aid-Investigations.pdf; *see also* Testimony of Robert B. Stack, Deputy Assistant Secretary (International Tax Affairs), U.S. Treasury Department, before the U.S. Senate Committee on Finance (Dec. 1, 2015), http://www.finance.senate.gov/imo/media/doc/01dec2015Stack.pdf; Vanessa Houlder & Christian Oliver, *US Treasury Voices Fears Over Corporate Tax Probes by Brussels*, Financial Times, Sept. 30, 2015, http://on.ft.com/1O1ECnj. On February 29, 2016, Commissioner for Competition Margrethe Vestager responded on behalf of President Juncker. Letter from Margrethe Vestager, European Commissioner for Competition, to Jacob J. Lew, U.S. Secretary of the Treasury (Feb. 29, 2016), http://static.politico.com/cf/ba/b7725d194d84a1df018c28160048/margrethe-vestager-letter-to-secty-lew-on-eu-tax-investigations.pdf [hereinafter Vestager Letter to Lew].

[14] Although this White Paper does not elaborate on the concern expressed in Secretary Lew's letter that the Commission's investigations are "targeting U.S. companies disproportionately," the U.S. Treasury Department remains concerned about this possibility, as the vast majority of the recovery amounts at stake are attributable to U.S. companies. This concern will be further heightened if the Commission continues to initiate disproportionately more investigations against U.S. companies.

undertaking, (3) is selective, and (4) affects trade between Member States and distorts competition.[15]

The Commission's recent decisions appear to deviate from established case law and its past practice in two ways. First, it appears that the Commission has collapsed the concepts of "advantage" and "selectivity," which are distinct requirements under State aid law. In the State Aid Cases, the Commission simply examined whether the measures at stake conferred a "selective advantage" on the companies under investigation, rather than separately assessing the existence of an advantage and the selective character of the measure, as it had done in prior decisions.

Second, under the Commission's new approach, an economic advantage provided to a multinational company, but not to a standalone one, would *a fortiori* meet the selectivity requirement. As detailed below, however, prior EU cases and Commission decisions show that disparate treatment attributed solely to the difference between multinational companies and standalone companies has not necessarily resulted in a tax measure being deemed selective. Instead, the typical analysis has been to compare multinational companies that benefited from a measure with multinationals that did not; this analysis has generally arisen in the context of an entire Member State tax regime that was applicable to companies meeting specific criteria. The Commission's position that individual transfer pricing rulings are selective when given to a particular multinational company, even when other multinational companies could have obtained them, constitutes a new approach that has not previously been applied.

A. The Commission's Newly Adopted Approach Collapses the Requirements of Advantage and Selectivity

According to the Commission, the "constituent elements" of State aid include granting an advantage and the selectivity of the measure.[16] An advantage means "any economic benefit which an undertaking could not have obtained under normal market conditions."[17] The advantage also has to be granted "in a selective way to certain undertakings or categories of undertakings or to certain economic sectors."[18] A foundational principle of EU State aid law is that advantage and selectivity are distinct elements. The Commission appears to have departed from this principle in the State Aid Cases.

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[15] *Air Liquide Industries Belgium SA v. Ville de Seraing a.o.*, Joined Cases C-393/04 & C-41/05, ECLI:EU:C:2006:403, ¶ 28.

[16] Commission Notice on the notion of State aid as referred to in Article 107(1) of the TFEU, 2016 O.J. C 262/1, ¶ 5 [hereinafter Notion of Aid Notice]. The other "constituent elements" of State aid are "the existence of an undertaking, the imputability of the measure to the State, its financing through State resources . . . and its effect on competition and trade between Member States." *Id.*

[17] *Id.* ¶ 66.

[18] *Id.* ¶ 117.

In its opening and final decisions in the State Aid Cases and in its recent Notice on the Notion of State Aid, the Commission relied heavily on its decision in *Belgian Coordination Centres* and on the ECJ's related judgment in *Belgium and Forum 187 ABSL.*[19] Yet in *Belgian Coordination Centres*, the Commission first assessed the existence of an advantage and then separately assessed whether the measure at stake was selective.[20] The ECJ took a similar approach in *Belgium and Forum 187 ABSL.*[21]

In general, *Belgian Coordination Centres* involved tax benefits that Belgium granted to Belgian companies that provided certain services to members of a multinational group. In determining that the regime constituted State aid, the Commission first found that the regime conferred an economic advantage because the benefits granted were not generally available under a normal application of the Belgian tax system. For example, contrary to the general rule of including all costs, a coordination centre was allowed to exclude certain costs from its cost base when determining its taxable income on a cost-plus basis. In addition, the centres were exempt from property tax on their buildings and were generally exempt from withholding tax on distributions: all taxes that would normally be owed by Belgian companies.[22]

Second, the Commission separately analyzed whether the advantages were selective.[23] The Commission found that selectivity arose "not from regional or sectoral criteria, but from the compulsory criteria which the centres and the groups to which they belong must satisfy in order to be approved and thereby to be able to take advantage of the scheme."[24] For example, to qualify for benefits the coordination centre had to meet certain criteria such as "size and multinational character of the group and the nature and type of activities carried out within it."[25] In short, a discrete analysis of selectivity followed the preliminary assessment of whether an

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[19] *Starbucks Decision*, ¶¶ 258-59; *Fiat Decision*, ¶¶ 222-23; *Amazon Opening Decision*, 2015 O.J. C 44/13, ¶ 54; *Apple Opening Decision*, 2014 O.J. C 369/22, ¶ 55; Notion of Aid Notice *supra* note 16, ¶ 171.

[20] *See Aid scheme implemented by Belgium for coordination centres established in Belgium*, Commission Decision 2003/755/EC, 2003 O.J. L 282/25 [hereinafter *Belgian Coordination Centres Decision*]; *see also Commission v. MOL Magyar Olaj-és Gázipari Nyrt.*, Case C-15/14 P, ECLI:EU:C:2015:362, ¶ 59 ("requirement as to selectivity under Article 107(1) TFEU must be clearly distinguished from the concomitant detection of an economic advantage"). Although a finding of economic advantage may sometimes give rise to a rebuttable *presumption* that selectivity is present, this is simply a burden shifting mechanism that does not eliminate the need to analyze selectivity. Furthermore, such presumption of selectivity arguably is inappropriate when analyzing income tax measures. *See* Liza Lovdahl Gormsen, *EU State Aid Law and Transfer Pricing: A Critical Introduction to a New Saga*, 7 Journal of European Competition Law & Practice 369, 374-75 (2016).

[21] *See Belgium and Forum 187 ABSL v. Commission*, Joined Cases C-182/03 & C-217/03, ECLI:EU:C:2006:416, ¶¶ 118, 122-23.

[22] *See generally Belgian Coordination Centres Decision*, 2003 O.J. L 282/25, ¶¶ 75-95; *see also Belgium and Forum 187 ABSL*, C-182/03 & C-217/03, ¶¶ 86-118.

[23] *Belgian Coordination Centres Decision*, 2003 O.J. L 282/25, ¶ 104-12; *see also Belgium and Forum 187 ABSL*, C-182/03 & C-217/03, ¶¶ 119-26.

[24] *Belgian Coordination Centres Decision*, 2003 O.J. L 282/25, ¶ 104.

[25] *Id*.

advantage existed.[26]

Commissioner Vestager has stated that since 1991, the Commission has concluded 65 cases involving State aid in relation to tax rulings and similar measures (not including pending investigations, or the recent decisions in *Belgian Excess Profit Scheme*, *Fiat*, and *Starbucks*).[27] A review of these 65 cases reveals that the Commission consistently assessed the existence of an advantage and the selective nature of the measure separately.[28]

The Commission departed from this practice in the opening decisions in *Apple* and *Amazon*, finding that selectivity was met simply because the ruling deviated from the arm's length principle—the same analysis used to find economic advantage.[29] In the *Starbucks* and *Fiat* final decisions, the Commission was even more explicit, stating that "where a tax measure results in an unjustified reduction of the tax liability of a beneficiary who would otherwise be subject to a higher level of tax under the reference system, that reduction constitutes both the advantage granted by the tax measure and the derogation from the system of reference."[30]

Previously, selectivity was often considered the "decisive criterion."[31] In the context of individual transfer pricing rulings, the selectivity requirement is a key hurdle for the Commission to overcome because individual rulings are generally available to any taxpayer and are granted based on an application of general Member State tax law. As a result, it is not surprising that in none of the 65 cases involving State aid nor in any other cases examined by the U.S. Treasury

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[26] The Commission relies heavily on the references to transfer pricing in paragraphs 95 and 96 of *Belgium and Forum 187 ABSL* (the ECJ judgment partially annulling and partially affirming the Commission's decision in *Belgian Coordination Centres*) to demonstrate that the Commission has always followed the same approach. In its opening decision in *Apple*, the Commission states that: "The Court of Justice has confirmed that if the method of taxation for intra-group transfers does not comply with the arm's length principle, and leads to a taxable base inferior to the one which would result from a correct implementation of that principle, it provides a selective advantage to the company concerned." *Apple Opening Decision*, 2014 O.J. C 369/22, ¶ 55 (citing paragraph 95 of *Belgium and Forum 187 ABSL*). However, no such confirmation can be taken from either paragraph 95 of *Belgium and Forum 187 ABSL* or the judgment as a whole. Paragraph 95 made clear that the "advantage" inquiry required a comparison of the regime with the "ordinary tax system" of Belgium, and as noted above, the decision in *Belgian Coordination Centres* analyzed selectivity wholly apart from the transfer pricing advantage that it found to exist in that case.

[27] Letter from Margrethe Vestager, European Commissioner for Competition, to Alain Lamassoure, President of the Special Tax Rulings Committee II, European Parliament (Apr. 29, 2015) (on file with author).

[28] *See, e.g.*, *Tax Incentives in favour of "International Trading Companies" and "Companies with Foreign Income"*, Commission Decision E6/2005, NN26/2005, E11/2005 & NN35/2005 (Mar. 22, 2006), ¶¶ 32-37, 40-44; *Foreign Income*, Commission Decision 2003/601/EC, 2003 O.J. L 204/51, ¶¶ 33, 38; *see also Spain and Lico Leasing v. Commission*, Joined Cases T-515/13 & T-719/13, ECLI:EU:T:2015:1004, ¶¶ 118, 125 (EU General Court agreed that while the tax measure provided an economic advantage to investors, it was not selective), *appeal brought*, *Commission v. Spain*, Case C-128/16 P, 2016 O.J. C 156/31.

[29] *See Apple Opening Decision*, 2014 O.J. C 369/22, ¶ 70; *Amazon Opening Decision*, 2015 O.J. C 44/13, ¶ 78.

[30] *Starbucks Decision*, ¶ 253; *Fiat Decision*, ¶ 217.

[31] Gormsen, *supra* note 20, at 375.

Department, did the Commission challenge how a Member State tax authority applied its own transfer pricing rules in granting a specific ruling.[32]

The Commission's new approach of collapsing the advantage and selectivity requirements has important substantive significance. Now, the Commission can find advantage if it disagrees with the Member State's application of the arm's length principle to particular, and often highly complicated, facts and circumstances. The Commission's new approach therefore reduces a State aid inquiry to whether the Commission believes that a transfer pricing ruling satisfies its view of the arm's length principle. This shift in approach appears to expand the role of the Commission's Directorate-General for Competition ("DG COMP") beyond enforcement of competition and State aid law under the TFEU into that of a supra-national tax authority that reviews Member State transfer price determinations. The cases cited by the Commission do not give taxpayers prior notice that the Commission would interpret its powers in this way or that selectivity would no longer be a meaningful precondition to a finding of State aid.

In the State Aid Cases, the Commission challenges neither the Member States' practice of granting transfer pricing rulings nor the substance of Member States' actual transfer pricing laws. Rather, the Commission is challenging the substance of particular Member State rulings; specifically, whether the arm's length prices described in the rulings were accurately determined. The Commission's challenge is based not on the arm's length standard as enshrined in Member State law but, as described further in Part IV below, on the Commission's own arm's length standard which has never before been articulated. Not only is such application of State aid law new, but taxpayers and Member States could not have foreseen that the Commission would apply this new standard.

B. Under Prior Decisions an Advantage Available Only to Multinationals Is Not Necessarily Selective

The Commission's justification for combining the advantage and selectivity requirements appears to be that because an advantage arises from deviations from the arm's length principle pursuant to a transfer pricing ruling, and a transfer pricing ruling is available only to multinational companies, then the advantage is also selective because it provides a benefit to particular multinational taxpayers but not to standalone companies, which must pay market prices.[33] Furthermore, in her letter to Secretary Lew, Commissioner Vestager asserted that "EU Courts have long established that under EU State aid rules Member States cannot give

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[32] In *Technolease*, the Commission analyzed an individual ruling that approved a sale-leaseback transaction and concluded that the ruling was not selective because the Member State had "merely . . . applied general tax rules." *Treatment by the Netherlands tax authorities of a technolease agreement between Philips and Rabobank,* Commission Decision 2000/735/EC, 2000 O.J. L 297/13, ¶ 36 [hereinafter *Technolease Decision*]. The Commission considered that the transaction had to be arm's length to comply with the Member State's general tax law, but did not actually scrutinize the ruling's transfer pricing analysis, observing simply that the tax authority had "tested and approved the transfer price" based upon the OECD TP Guidelines. *Id.* ¶ 32.

[33] *See, e.g.*, *Starbucks Decision*, ¶ 267; *Fiat Decision*, ¶ 217; Notion of Aid Notice, *supra* note 16, ¶ 172.

multinational groups a more favourable tax treatment than standalone companies."[34] But under EU case law and the Commission's own prior decisions, the selectivity requirement is not necessarily met when a multinational company receives a potential tax benefit that is not applicable to a standalone company.

To be selective, a measure must provide a benefit to certain undertakings "in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question."[35] This analysis requires first "identifying and examining the common or 'normal' regime," or the reference framework.[36] Then, a measure that provides an economic advantage is held to be selective if it "derogates from that common regime inasmuch as it differentiates between economic operators who, in the light of the objective assigned to the tax system of the Member State concerned, are in a comparable factual and legal situation."[37] However, a derogation that is "justified by the nature or general scheme of the system of which it is part" is not selective.[38]

As discussed above, the Commission concluded in *Belgian Coordination Centres* that the tax benefits provided were selective because a company had to meet specific conditions to qualify for the regime, including the existence of subsidiaries in at least four countries and thresholds for revenue and number of employees in Belgium.[39] It is because of such a strict definition of the multinational character of a group that the ECJ, in deciding an action for annulment of the Commission's decision, agreed that the Belgian coordination centre regime was indeed selective.[40]

Belgian Coordination Centres demonstrates that the Commission's prior approach has been to compare multinational companies that were able to benefit from the regime to multinational companies that could not benefit. Accordingly, the case does not presage the Commission's new approach of finding that a difference in treatment between multinational groups and standalone companies is *a fortiori* selective.

Of the aforementioned 65 cases cited by Commission, none resulted in a finding that a given measure could be treated as selective solely because it resulted in disparate treatment between multinational groups and standalone companies. Instead, in each case where

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[34] Vestager Letter to Lew, *supra* note 13.

[35] *Portugal v. Commission*, Case C-88/03, ECLI:EU:C:2006:511, ¶ 54 (citing, among others, *Adria-Wien Pipeline*, Case C-143/99, ECLI:EU:C:2001:598, ¶ 41).

[36] *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. Paint Graphos Soc. coop. arl and Others*, Joined Cases C-78/08 to C-80/08, ECLI:EU:C:2011:550, ¶ 49; *see also* Notion of Aid Notice, *supra* note 16, ¶ 128.

[37] *Paint Graphos,* C-78/08 to C-80/08, ¶ 49 (citing *Portugal v. Commission,* C-88/03, ¶ 56); *see also* Notion of Aid Notice, *supra* note 16, ¶ 128.

[38] *Adria-Wien Pipeline*, C-143/99, ¶ 42; *see also* Notion of Aid Notice, *supra* note 16, ¶ 128.

[39] *See Belgian Coordination Centres Decision*, 2003 O.J. L 282/25, ¶¶ 13 n.14, 104.

[40] *See Belgium and Forum 187 ABSL*, C-182/03 & C-217/03, ¶¶ 122-23.

multinational companies were implicated, there were additional conditions that distinguished the multinational companies that benefited from those that did not. For example, in several cases the measure was found selective when, in order to benefit from the measure, a multinational group had to operate in a certain number of foreign countries,[41] meet certain monetary thresholds,[42] satisfy certain ownership requirements,[43] or the measure applied only to certain types of intra-group activities.[44] Furthermore, in *Hungarian Intra-Group Interest*, the Commission agreed that standalone companies are not necessarily an appropriate comparison when determining whether a measure available only to multinational companies is selective, stating that intercompany loans are not comparable to loans with unrelated parties because "[w]ith respect to debt financing activities, related companies are not in a comparable legal and factual situation with unrelated companies."[45] Instead, the Commission's practice is to determine which other companies are in a comparable legal and factual situation by analyzing the particular facts and circumstances of the case.

In fact, the following four cases have resulted in express findings that the contested measure was not selective (and therefore did not constitute State aid) even though the measure treated multinational companies differently from standalone ones:

- In *Irish Company Holding Regime*, the measure was available only to Irish companies with foreign subsidiaries (which, by definition, excludes standalone Irish companies). The Commission decided that the measure was not selective because it applied "without

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[41] *Aid scheme implemented by Spain in favour of coordination centres in Vizcaya*, Commission Decision 2003/81/EC, 2003 O.J. L 31/26, ¶¶ 11, 32 [hereinafter *Spanish Coordination Centres Decision*] (two foreign countries); *State aid scheme – Coordination Centres – implemented by Luxembourg*, Commission Decision 2003/501/EC, 2003 O.J. L 170/20, ¶ 53 [hereinafter *Luxembourg Coordination Centres Decision*] (two foreign countries); *Aid scheme – Finance Companies – Implemented by Luxembourg*, Commission Decision 2003/438/EC, 2003 O.J. L 153/40, ¶ 48 [hereinafter *Luxembourg Finance Companies Decision*] (two foreign countries); *State aid scheme – central corporate treasuries – implemented by France*, Commission Decision 2003/883/EC, 2003 O.J. L 330/23, ¶ 31 (three countries); *State aid implemented by the Netherlands for international financing activities*, Commission Decision 2003/515/EC, 2003 O.J. L 180/52, ¶ 87 [hereinafter *Dutch International Financing Decision*] (four countries or two continents).

[42] *Spanish Coordination Centres Decision*, 2003 O.J. L 31/26, ¶¶ 11, 32 (capital and revenue thresholds); *Luxembourg Coordination Centres Decision*, 2003 O.J. L 170/20, ¶ 54 (minimum expenditure threshold); *Luxembourg Finance Companies Decision*, 2003 O.J. L 153/40 ¶ 49 (minimum capital expenditure threshold).

[43] *Aid scheme implemented by Germany for control and coordination centres*, Commission Decision 2003/512/EC, 2003 O.J. L 177/17, ¶ 32 [hereinafter *German Coordination Centres Decision*] (scheme available only to companies belonging to groups with foreign headquarters).

[44] *German Coordination Centres Decision*, 2003 O.J. L 177/17, ¶ 32; *Dutch International Financing Decision*, 2003 O.J. L 180/52, ¶ 87.

[45] *State Aid implemented by Hungary for tax deductions for intra-group interest*, Commission Decision 2010/95/EC, 2010 O.J. L 42/3, ¶ 111. The Commission noted that unlike unrelated parties, related companies are not engaged in a merely commercial transaction but rather share the same interests. *Id.*

distinction to all firms and to the production of all goods within the regime."[46] Therefore, the appropriate comparison was between multinational companies that benefited from the regime versus those that did not. Since the Irish regime allowed all multinational companies to take advantage of the measure, the Commission agreed it was not selective.

- In *Dutch Groepsrentebox Scheme*, the measure was available to companies that exercised control over another company, and such criterion applied "across the board to all companies regardless of size, sector or any other distinction."[47] Standalone companies were not in a comparable situation as groups with related parties since, according to the Commission, "a different rate of taxation for debt financing between related parties merely reflects objective differences and does not affect tax neutrality."[48] Furthermore, the Commission decided that even if the appropriate comparison is between multinational and standalone companies, a measure available only to multinational companies is not selective if standalone companies could participate simply by forming a foreign affiliate as "a mere matter of organisation, without disproportionate costs," and thus become multinational in character and eligible for the measure.[49]

- In *Autogrill Espana*, the EU General Court annulled a Commission decision that Spain's regime allowing companies to amortize goodwill for acquisitions of foreign subsidiaries constituted State aid. The Court held the measure was not selective because in order to become eligible, any company, including a standalone company, simply had to purchase shares of a foreign company. Such an acquisition was "entirely financial," does not require the company to "change its activity," and involves "only limited responsibility with regard to the investment made."[50] A contrary rule, the EU General Court explained, could "lead to every tax measure the benefit of which is subject to certain conditions being found to be selective, even though . . . [other undertakings] would be capable of satisfying the conditions."[51] This would render the selectivity prong virtually moot given that any tax measure that provides a benefit almost always comes with some conditions.

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[46] *State aid – Ireland Company Holding Regime*, Commission Decision COMP/N 354/2004 (Sept. 22, 2004), ¶ 16 (decision published in the Official Journal at 2005 O.J. C 131/10).

[47] *Groepsrentebox scheme which the Netherlands is planning to implement,* Commission Decision 2009/809/EC, 2009 O.J. L 288/26, ¶ 104 [hereinafter *Dutch Groepsrentebox Scheme Decision*].

[48] *Id.*

[49] *Id.* ¶¶ 125-27. In contrast, to the extent the measure contained more significant impediments (such as "requiring a certain economic strength or significant capital resources"), it would raise selectivity concerns. *Id.* ¶ 127.

[50] *Autogrill Espana, SA v. Commission*, Case T-219/10, ECLI:EU:T:2014:939, ¶¶ 55-57, *appeal brought*, *Commission v. World Duty Free Group*, Case C-20/15 P, 2015 O.J. C 81/10. On July 28, 2016, the Advocate General delivered his opinion proposing that the General Court's judgment in *Autogrill Espana* be annulled, although the ECJ has not yet rendered a judgment. Opinion of Advocate General Wathelet, *Commission v. World Duty Free Group*, Joined Cases C-20/15 P & C-21/15 P, ECLI:EU:C:2016:624.

[51] *Autogrill Espana*, T-219/10, ¶ 68.

- In *Lico Leasing,* taxpayers seeking to obtain certain benefits from the Spanish Tax Lease System had to obtain prior authorization from the Spanish tax authorities. The EU General Court, expanding on its judgment in *Autogrill Espana*, rejected the Commission's argument that such authorization system with discretionary elements was selective, holding that any discretion resulted "only in the definition of the type of operation eligible to benefit from the tax advantages at issue," which was simply "a condition for the application of the advantage, from which any undertaking active in any sector of the economy could benefit."[52]

Although the judgments in *Autogrill Espana* and *Lico Leasing* are on appeal to the ECJ, these judgments call into question the accuracy of the Commission's statement that "EU Courts have long established that under EU State aid rules Member States cannot give multinational groups a more favourable tax treatment than standalone companies."[53] The EU General Court's judgments in *Autogrill Espana* and *Lico Leasing* against the Commission suggest that the Commission's position is not one that has been settled in the EU by "long established" precedent.

Companies and countries analyzing prior Commission decisions on specific tax regimes, including the aforementioned cases, could have reasonably concluded that measures available to all companies with foreign affiliates but not to domestic companies without foreign affiliates were not, solely by virtue of this difference, selective measures. In particular, they could have concluded that a transfer pricing ruling that was granted in good faith by a Member State tax authority, was consistent with Member State law, and could have been available to any other similarly-situated applicant,[54] would not have been found to be selective merely because a standalone company could not obtain the ruling or because the Commission might disagree with the Member State's interpretation of the arm's length principle.

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Under a traditional selectivity analysis, a tax measure that benefits only multinational companies but not standalone ones could not be selective because multinational and standalone companies are not in a comparable legal or factual position. In the State Aid Cases, there is no

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[52] *Spain and Lico Leasing*, T-515/13 & T-719/13, ¶ 160-61.

[53] Vestager Letter to Lew, *supra* note 13.

[54] In *Technolease*, the Commission noted that "[a]nother way to establish whether general tax rules have been applied is by checking whether other enterprises actually could [avail themselves of the scheme]." The Commission noted that further proof of non-selectivity could be found in that, based on press releases, other enterprises comparable to the taxpayer at issue felt that the same tax benefit was open to them. *See Technolease*, 2000 O.J. L 297/13, ¶ 37. Similarly, it is the U.S. Treasury Department's understanding that any taxpayer could have obtained rulings similar to the ones granted in the State Aid Cases, or could have used the same transfer pricing methodologies even without a ruling. *See also MOL Magyar*, C-15/14 P, ¶ 91 (noting that fact that only one taxpayer obtained a ruling is not sufficient to establish selectivity since that may be due simply to the "lack of interest" by other taxpayers).

evidence (and the Commission has not argued) that other multinational companies could not have obtained the same rulings as the companies now under investigation. Even if a comparison between multinationals and standalones were appropriate, the Commission has not demonstrated that a standalone company could not obtain similar rulings as the ones being challenged simply by forming or acquiring a foreign affiliate, or operating cross border through a branch. By collapsing selectivity into advantage, the Commission's approach in the recent investigations departs from its longstanding methodology.

III. The Commission Should Not Seek Retroactive Recoveries Under Its New Approach

Where State aid involves impermissible subsidies provided through the tax system, the Commission requires the Member State to recover the amount of tax that, in the Commission's view, should have been imposed in the first place. These amounts can be significant, since the Commission can require recovery for up to ten prior years, with interest for the period the illegal aid is granted until the aid is recovered.[55] In *Fiat* and *Starbucks*, the Commission has ordered the Member States to recover the allegedly unpaid tax with respect to prior tax years.[56] Because the Commission's approach in the State Aid Cases is new and was not foreseeable by the relevant companies, recovery of past allegedly unpaid tax would constitute retroactive enforcement of a newly adopted approach to State aid.

With no indication of the Commission's new approach, U.S. companies have been receiving transfer pricing rulings from EU Member States for decades and had no reason to doubt their legality. Under these circumstances, recovery of past allegedly unpaid tax would be inconsistent with EU legal principles and the Commission should avoid retroactive enforcement.

A. Retroactive Recoveries Are Inconsistent with EU Legal Principles

The Council Regulation on State aid provides that "[t]he Commission shall not require recovery of the aid if this would be contrary to a general principle of Union law."[57] As a general matter, retroactive enforcement runs counter to one of the fundamental principles of EU jurisprudence: the principle of legal certainty. According to ECJ case law, the principle of legal certainty "requires that European Union rules enable those concerned to know precisely the extent of the obligations imposed on them, and that those persons be able to ascertain unequivocally what their rights and obligations are and take steps accordingly."[58] Rules of law

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[55] *See* Council Regulation (EU) 2015/1589 laying down detailed rules for the application of Article 108 of the TFEU, 2015 O.J. L 248/9, arts. 16-17 (July 13, 2015) [hereinafter Council Regulation on State aid]; Commission Regulation (EC) 794/2004 implementing Council Regulation (EC) 659/1999, 2004 O.J. L 140/1, art. 11.

[56] *See* Commission Press Release IP/15/5880, *Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules* (Oct. 21, 2015).

[57] Council Regulation on State aid, *supra* note 55, art. 16(1); *see also* Council Regulation (EC) 659/1999 laying down detailed rules for the application of 93 of the EC Treaty, 1999 O.J. L 83/1 (March 22, 1999), as amended, art. 14(1).

[58] *Commission v. Spain*, Case C-610/10, ECLI:EU:C:2012:781, ¶ 49 (internal citations omitted).

must "be clear and precise and predictable in their effect, so that interested parties can ascertain their position in situations and legal relationships governed by EU law."[59]

As explained above in Part II, public guidance—including Commission decisions and notices as well as EU case law—suggested that the tax rulings issued in the State Aid Cases were consistent with the Commission's application of State aid rules to transfer pricing cases. Moreover, Member States made tax assessments pursuant to these rulings for a long period of time—in some cases for well over ten years—with no enforcement action by the Commission or any other indication from the Commission that its approach to analyzing tax rulings under State aid law was about to change.[60] This could have reasonably reinforced an understanding among all parties that the legal determinations of Member States were consistent with EU law and practice. None of the companies under investigation had identified the risk of State aid investigations in audited financial disclosures made prior to June 11, 2014 (the date that the Commission announced and opened its formal investigations of Ireland, Netherlands, and Luxembourg concerning Apple, Starbucks, and Fiat, respectively). Moreover, it is our understanding that, until the Commission had started its inquiries and investigations, neither internal review nor third-party review and audit of the affected firms by tax and audit professionals gave rise to any determination that their tax treatment could potentially be subject to State aid rules.

Accordingly, it would be reasonable to conclude that the Commission has not provided sufficient advance notice to the companies involved in the State Aid Cases "to know precisely the extent of the obligations imposed on them" and to allow them to "be able to ascertain unequivocally what their rights and obligations are and take steps accordingly."

B. The Commission Should Decline to Impose Retroactive Recoveries

The Commission's prior practice shows that it has previously avoided retroactive recoveries when companies and Member States were not on notice that the Commission would take a new approach. Consistent with this prior practice, the Commission should avoid imposing retroactive recoveries in the State Aid Cases.

For example, in *German Coordination Centres*, Germany adopted a scheme in 1985 that, while distinct, had "some features in common with" the Belgian scheme at issue in *Belgian Coordination Centres*.[61] In a 1984 decision, the Commission had concluded that the Belgian scheme did not constitute State aid.[62] The decision was not published, but the Commission had

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[59] *France Telecom SA v. Commission*, Case C-81/10 P, ECLI:EU:C:2011:811, ¶ 100.

[60] For example, Apple relied on tax rulings issued by Ireland in 1991 and 2007. *Apple Opening Decision*, 2014 O.J. C 369/22, ¶ 30. Amazon obtained its tax ruling from Luxembourg in 2003. *Amazon Opening Decision*, 2015 O.J. C 44/13, ¶ 27.

[61] *German Coordination Centres Decision*, 2003 O.J. L 177/17, ¶ 43.

[62] *Id.*

stated that it had no objections to the Belgian scheme in a 1985 annual report on competition policy and in response to a parliamentary question in 1991.[63] In 2002, the Commission determined that the German coordination centre scheme did in fact constitute illegal State aid but it did not impose retroactive recovery because "it can be argued" that the Commission's two previous public statements validating the Belgian scheme conferred a legitimate expectation on Germany and the aid beneficiaries.[64] Accordingly, the Commission sought only prospective relief.[65] The Commission later adopted the same prospective approach in decisions involving similar coordination center regimes.[66]

In the various coordination centre cases, as in the State Aid Cases, the beneficiaries of any alleged State aid had no reason to doubt the legality of the Member State regime until the Commission's later decision. As a result, the Commission did not seek retroactive recoveries. The Commission chose to avoid retroactive recovery simply because it "can be argued" that the Member State and companies had legitimate expectations of the legality of the coordination centre regime, despite the minimal public notice given of the prior 1984 decision.[67] Thus, if desirable, the Commission is able to avoid seeking retroactive recoveries. The result in these coordination centre cases is particularly salient because the Commission relies heavily on them to support its legal approach in the State Aid Cases.

Although in the State Aid Cases the Commission did not issue any public statement that the tax rulings in question did *not* constitute State aid, the principle is the same. Here, the longstanding inaction by the Commission—in addition to the fact that the Commission provided no hints of its new approach in previous guidance—warrants the Commission declining to impose retroactive recoveries.

Furthermore, avoiding retroactive recoveries in these cases is consistent with broader efforts taken by the international community to improve tax certainty. In its July 2016 communiqué, the G20 highlighted the "benefits of tax certainty to promote investment and

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[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *See Aid scheme implemented by France for headquarters and logistics centres*, Commission Decision 2004/76/EC, 2004 O.J. L 23/1, ¶¶ 81-82; *Aid scheme implemented by Belgium – Tax ruling system for United States foreign sales corporations*, Commission Decision 2004/77/EC, 2004 O.J. L 23/14, ¶¶ 77-78; *Luxembourg Coordination Centres Decision*, 2003 O.J. L 170/20, ¶¶ 68-69; *Luxembourg Finance Companies Decision*, 2003 O.J. L 153/40, ¶¶ 63-64; *see also Belgium and Forum 187 ABSL*, C-182/03 & C-217/03, ¶¶ 147-67; *Belgian Coordination Centres Decision*, 2003 O.J. L 282/25, ¶¶ 117-20.

[67] No analysis regarding the Belgian scheme was published. The 1985 report on competition policy stated the Commission had no objection to Belgium's coordination centre regime, but it provided no analysis or statement of reasons. *See* Commission of the European Communities, *Fourteenth Report on Competition Policy* 237 (1985). Similarly, in response to a parliamentary question, the Commission acknowledged that coordination centre regimes do not fall within the scope of State aid but did not explain why. Commission Answer to Written Question 1735/90, 1991 O.J. C 63/37.

trade," while asking the OECD and International Monetary Fund to continue working on the issue of tax certainty.[68] The U.S. Treasury Department strongly supports this work, which will play an important role in ensuring that the effort to combat BEPS is done in a fair and predictable manner that does not unnecessarily impede cross-border investment and trade. In contrast, the Commission's application of a new and unforeseeable approach that results in large recoveries related to past conduct creates significant uncertainty for companies. The Commission's pursuit of retroactive recoveries is not only in tension with the G20's efforts to emphasize tax certainty, but also sets an undesirable precedent that could lead to other tax authorities, particularly those in developing countries that look to the EU as a model, to seek large and punitive retroactive recoveries from both U.S. and EU companies.[69]

IV. The Commission's New Approach Is Inconsistent with International Norms and Undermines the International Tax System

The U.S. Treasury Department acknowledges that EU State aid law may sometimes preempt conflicting Member State law, including income tax law. But Member States apply their domestic tax rules in a variety of contexts that have not traditionally been understood to constitute State aid. For example, Member State tax authorities choose which taxpayers and issues to audit; they make audit adjustments; they settle cases on appeal and in their courts; and, as particularly relevant here, they grant tax rulings, including advance pricing agreements. While the U.S. Treasury Department appreciates that Member States cannot apply their tax rules in a way that violates State aid law, the Commission nevertheless should avoid disturbing long-settled understandings in the international tax system.

The Commission's approach in the State Aid Cases involves establishing a competing EU-only arm's length principle that is not tied to the global consensus embodied in the OECD TP Guidelines. In doing so, the Commission's actions undermine the international consensus on transfer pricing standards, call into question the ability of Member States to honor their bilateral tax treaties, and undermine the progress made under the BEPS project.

A. Background on the OECD's Role in Setting Transfer Pricing Standards

Multilateral efforts to address transfer pricing resulted from the need to avoid double taxation. In contrast to income earned in a purely domestic context, cross-border income can be subject to tax by multiple countries. Because no higher-level authority exists to resolve differences between countries on how to tax the same income, double taxation may result. To

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[68] Communiqué, G20 Finance Ministers and Central Bank Governors Meeting (Chengdu, China, July 23-24, 2016), ¶ 11, http://www.mof.go.jp/english/international_policy/convention/g20/160724.htm.

[69] At the High Tax Symposium recently held as part of the G20 meetings in Chengdu, China, Secretary Lew noted that enacting retroactive tax laws creates uncertainty for both taxpayers and tax authorities, stating that "[t]ax [laws] should be prospective so companies know what rules they're complying with as they do business in a country." At the same meeting, German Finance Minister Wolfgang Schäuble also called on countries to avoid retroactive changes to their tax laws. Stephanie Soong Johnston, *G-20 Officials Warn Against Public Country-by-Country Reporting*, Tax Notes Today, July 26, 2016.

minimize the risk of double taxation and disputes between countries, the international community developed a set of standards for allocating income among jurisdictions. These standards include the use of the arm's length principle for transfer pricing and the development of treaty networks to resolve disputes. The OECD—an organization that includes the United States as well as most EU Member States, including Belgium, Ireland, Luxembourg, and the Netherlands—developed many of these standards, which have succeeded for decades in maintaining a consensus regarding minimizing double taxation and resolving disputes.[70]

The OECD develops and publishes consensus guidance regarding the interpretation and application of the arm's length principle. The OECD TP Guidelines provide general guidance on transfer pricing methods and selection thereof, comparability analysis, and administrative approaches to resolving transfer pricing disputes, as well as special guidance for specific fact patterns including intangible property, intragroup services, cost contribution arrangements, and business restructurings.

OECD members often incorporate the OECD TP Guidelines directly into their domestic law.[71] Thus, taxpayers must adhere to the arm's length principle, as articulated in the OECD TP Guidelines, to determine intercompany transfer pricing for cross-border transactions. In addition, the OECD TP Guidelines form the basis for mutual agreement by competent authorities (generally the relevant countries' national tax authorities) to resolve cases of potential double taxation when two countries disagree about the application of the arm's length principle to a particular taxpayer.

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[70] Even before the creation of the OECD and the development of its TP Guidelines, countries were faced with the issue of attributing an appropriate amount of taxable income to their jurisdiction in the case of cross-border activity that occurred partially in their jurisdiction. In the absence of treaties, these rules are wholly a matter of domestic law and take a variety of forms around the world. They share the same goal of trying to estimate the profits that should be attributed to the activities taking place in the jurisdiction imposing the tax. In the 1920's, as international trade grew, countries began to enter into treaties that enshrined the arm's length standard as the way to determine pricing between affiliated entities in order to determine the taxable income attributed to each jurisdiction that was a party to the treaty. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke Law Journal 1021, 1074-89 (1997). The OECD TP Guidelines can be understood as the memorialization and increasing articulation of the international consensus on the application of the arm's length principle and the related issue of the attribution of profits to activity conducted in branches. Therefore, even if a country has not adopted the OECD TP Guidelines and its treaties are not modeled on the OECD Model Convention and its commentary, the country likely has adopted and utilized concepts and principles that were consistent with the broad principles underlying that work. *See also Fiat Decision*, ¶ 87 ("[I]in general, the OECD TP Guidelines serve as a focal point and exert a clear influence on the tax practices of OECD member (and even non-member) countries.").

[71] According to the Commission's decisions in the State Aid Cases, the Netherlands, Luxembourg, and Belgium all generally incorporate the OECD TP Guidelines into domestic law. *See Starbucks Decision*, ¶ 411; *Fiat Decision*, ¶ 77; *Belgium Excess Profit Scheme Decision*, ¶ 33. We understand that Ireland incorporated the OECD TP Guidelines into its domestic law in 2010. *See also Fiat Decision*, ¶ 87 ("[I]n numerous OECD member countries [the OECD TP Guidelines] have been given the force of law or serve as a reference for the purpose of interpreting domestic tax law.").

Beginning in 2013, as part of the OECD/G20 BEPS project, the OECD and G20 members updated the OECD TP Guidelines to strengthen the ability of tax administrations to combat base erosion and profit shifting arising from transfer pricing that is inconsistent with the arm's length principle. The BEPS transfer pricing work, carried out under Actions 8-10 of the BEPS Action Plan, focused on clarifying and strengthening the portions of the OECD TP Guidelines related to intangibles and risks in a way that ensures that income is aligned with value creation.

The OECD and G20 members' work has improved protections against base erosion and profit shifting. All the leaders in the G20, including Commission Presidents, have endorsed the BEPS project and its outputs. The resulting clarifications to the OECD TP Guidelines proceeded through the same process followed since the OECD countries produced the first version of the Guidelines in 1995: a consensus-based multilateral approach that helps ensure consistency in both the interpretation of the arm's length principle and in its practical application by taxpayers and tax authorities throughout the world.

B. The Commission's Actions Undermine the International Consensus on Transfer Pricing

As part of its analysis in *Starbucks*, *Fiat*, and *Belgium Excess Profit Scheme* of whether a tax ruling confers a selective advantage, the Commission asserts that "the arm's length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention and the OECD TP Guidelines . . . but a general principle of equal treatment in taxation falling within the application of Article 107(1) of the [TFEU]."[72] With this statement, the Commission appears to assert that all transfer pricing determinations in the EU must now meet two distinct arm's length tests: one established by the Member State as set forth in the OECD TP Guidelines and one without any articulated analytical framework based on "equal treatment" principles of the TFEU.[73] The Commission will now have its own concept of the arm's length principle without having previously provided any guidance on what the arm's length principle under the TFEU means. As a result, the Commission now appears to have become an arbiter of when a transfer price relevant for determining taxable income in a Member State satisfies the arm's length principle.[74]

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[72] *Starbucks Decision*, ¶ 264; *Fiat Decision*, ¶ 228; *Belgian Excess Profit Scheme Decision*, ¶ 150.

[73] *See also* Notion of Aid Notice, *supra* note 16, ¶ 172 ("This arm's length principle necessarily forms part of the Commission's assessment of tax measures granted to group companies under Article 107(1) of the Treaty, *independently of whether a Member State has incorporated this principle into its national legal system and in what form*." (emphasis added)).

[74] Furthermore, the Commission has suggested that it may also become an arbiter of tax settlements agreed to by Member States with taxpayers. *See* Jim Brunsden & Josh Noble, *European Commission to examine Google's UK tax deal,* Financial Times, Jan. 28, 2016, http://on.ft.com/1PkD4WH; *see also* Notion of Aid Notice, *supra* note 16, ¶¶ 175-76. This would represent another new application of State aid law to income tax matters that are generally the prerogative of Member States and would raise additional practical and policy concerns beyond the scope of this paper.

Although the Commission has suggested that it "may have regard" for the OECD TP Guidelines and that a ruling in compliance with the OECD TP Guidelines is "unlikely" to give rise to State aid,[75] these statements only underscore the uncertainty precipitated by the Commission's actions.[76] Whether a tax ruling is consistent with the Guidelines will now be determined, in the first instance, by a non-tax agency that generally is not tasked with applying the Guidelines and was not involved in their development. This approach raises concerns because the Guidelines are not designed to reach formulaically precise results; rather, they describe a framework of analysis and methodologies that are highly dependent on each case's facts. For this reason, the tax authorities of the United States and EU Member States generally have entire departments whose sole responsibility is to examine transfer pricing issues.

The Commission maintains that it is focused on cases where there is "a manifest breach of the arm's length principle."[77] But the Commission has not articulated what it means by "arm's length principle," except for inchoate references to "the market." The Commission has indicated neither the circumstances that will cause a "breach" of the arm's length principle nor when such a breach will be considered "manifest," leaving Member States and companies without meaningful guidance on how the Commission intends to apply its version of the arm's length principle.

The U.S. Treasury Department's concern about the Commission's new approach is heightened by additional Commission statements that seem at odds with the OECD TP Guidelines. For example, the Commission has criticized the transactional net margin method ("TNMM"), which is an available method under the OECD TP Guidelines, because tax authorities applying that method "don't even try to split a company's profits between the countries that might have a claim to tax them. Instead, one country simply works out the taxable profit based on an indicator, such as operating expenses. But those figures can be a poor indicator of how successful a company is, so using them to set the taxable profit is only appropriate in a limited number of cases."[78] The Commission's recent working paper adds that "[a]n appropriate indicator is the one that best captures the commercial value of the activity."[79]

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[75] Notion of Aid Notice, *supra* note 16, ¶ 173.

[76] Moreover, the Commission does not explain where the OECD TP Guidelines depart from the so-called "market-based outcome" purportedly required under the Treaty, making it difficult to judge the likelihood that the two approaches will lead to different results in practice.

[77] *DG Competition Working Paper on State Aid and Tax Rulings*, ¶ 23 (June 3, 2016), http://ec.europa.eu/competition/state_aid/legislation/working_paper_tax_rulings.pdf [hereinafter DG COMP Working Paper].

[78] *See* Margrethe Vestager, European Commissioner for Competition, Speech at the High Level Forum on State Aid Modernisation: The EU State aid rules: working together for fair competition (June 3, 2016), https://ec.europa.eu/commission/2014-2019/vestager/announcements/eu-state-aid-rules-working-together-fair-competition_en; *see also* DG COMP Working Paper, *supra* note 77, ¶ 22 ("In some cases, it seems that this choice of operating expenses as a performance indicator is made systematically, without necessarily representing the commercial value of the functions of the company.").

[79] DG COMP Working Paper, *supra* note 77, ¶ 22.

Not only do these statements suggest the Commission may have a different view of the TNMM than the OECD TP Guidelines,[80] but they also articulate no criteria from which a taxpayer or a Member State competent authority, seeking to avoid a conflict with the Commission, can determine how to correctly apply the TNMM (such as knowing which indicators are "appropriate" and which are "poor.").

In *Starbucks*, the Commission not only rejected the Member State and taxpayer's agreement to use the TNMM, but also decided that the comparable uncontrolled price ("CUP") method should have been used because purportedly reliable comparable transactions were available.[81] According to the Commission's analysis, no (zero) royalty should be treated as having been paid by the relevant Starbucks entity, which it believes did not derive any benefit from intellectual property related to proprietary roasting activities.[82] Although we do not have enough information to evaluate how the OECD TP Guidelines would apply to the facts of the Starbucks case, the Commission's application of its version of the arm's length principle seems to result in an allocation of significant profits, which are likely related to intellectual property, to an entity that does not appear to own or develop any intellectual property and that operates in a limited risk capacity. While its decision discusses Member State law and the OECD TP Guidelines, the Commission states that its reasoning is based on neither of those but instead on the TFEU's general principle of equal treatment in taxation.[83] But the U.S. Treasury Department is aware of no guidance from the Commission on how the TFEU's general principle of equal treatment would apply to allocate value from intellectual property, one of the most difficult and complex areas of transfer pricing.[84]

Various statements by the Commission invite speculation as to whether the Commission's view of the arm's length standard depends on the relative tax rates of the countries on either side of a transaction. For example, the Deputy Director-General of DG COMP has stated that "[i]f multinationals are able to adjust their transfer pricing to *shift profits to low- or no-tax countries, or otherwise avoid paying taxes due*, then they can operate in the internal market without paying the taxation that their competitors are subject to."[85] Yet, the

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[80] *Cf.* Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, ¶¶ 2.2, 2.58-2.67 (2010).

[81] *Starbucks Decision*, ¶¶ 285, 299.

[82] *Id.* ¶ 339.

[83] *Id.* ¶¶ 264-65.

[84] For example, the Commission has provided no guidance on the extent to which intellectual property ownership, development, or risk-taking affects the amount of income allocable to a jurisdiction. In contrast, and as discussed below in Part IV.D, participants in the G20/OECD BEPS project have spent several years negotiating and developing rules for applying the arm's length principle to intellectual property.

[85] Santhie L. Goundar, *European Commission Defends State Aid Investigations of Tax Rulings*, Worldwide Tax Daily, June 22, 2016 (emphasis added).

Commission's own decisions indicate that such considerations should not be relevant to a State aid analysis.[86]

In addition, in *Fiat*, the Commission stated that a second-best method may still satisfy the arm's length principle as derived from Article 107(1) of the TFEU if the method is used with an "overly conservative set of parameters."[87] In contrast, even applying the most appropriate method may constitute State aid if used with "overly favourable parameters."[88] These instructions appear to be premised on the notion that as long as the taxpayer has left sufficient income in the Member State to be taxed, then the TFEU's "general principle of equal treatment in taxation" is satisfied. Yet such outcome-determinative reasoning is inconsistent with the logic of the arm's length principle, which is neutral as to which jurisdiction ends up with the income as long as the allocation is generally consistent with what unrelated companies otherwise would pay.[89]

C. The Commission's Actions Call into Question the Ability of Member States to Honor Bilateral Tax Treaties

Transfer pricing disputes are the largest area of income tax controversy between countries. These disputes are intensely fact-based, and billions of dollars can be at stake. The international tax system has relied heavily on the obligation to attempt to resolve these disputes through the mutual agreement procedures ("MAP") found in bilateral tax treaties. As part of Action 14 of the BEPS project, all OECD members and all G20 members, including the EU, agreed that "this mechanism—the mutual agreement procedure—is of fundamental importance to the proper application and interpretation of tax treaties."[90] Under Action 14, countries decided on a minimum standard to ensure that taxpayers have access to MAP when eligible, and that MAP cases should be resolved in a timely manner.

Under MAP, countries use the OECD TP Guidelines to determine what constitutes an arm's length price. The countries collectively endeavor to ensure a neutral interpretation of the arm's length principle that applies fairly and consistently regardless of a country's particular circumstances, such as whether it is primarily a capital importer or exporter, or is a high- or low-tax jurisdiction. Because of the fact-based nature of transfer pricing determinations, achieving

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[86] For example, in *Dutch Groepsrentebox Scheme*, the Commission stated that the "existence of disparities between tax systems in a cross-border situation" could not give rise to State aid since such disparities are not "imputable" to the Netherlands. *Dutch Groepsrentebox Scheme Decision*, 2009 O.J. L 288/26, ¶ 125.

[87] *Fiat Decision*, ¶ 243.

[88] *Id.* ¶ 244.

[89] Representatives of DG COMP have also publicly stated that they are focused only on "outliers." Goundar, *supra* note 85. While this may simply be an acknowledgment of enforcement priorities, the Commission's decisions appear to embed this enforcement priority logic into its legal analysis, which further obscures what it defines as the arm's length principle derived from the TFEU's general principle of equal treatment in taxation.

[90] Organisation for Economic Co-operation and Development, *Making Dispute Resolution Mechanisms More Effective, Action 14: 2015 Final Report*, at 9 (2015).

agreement often requires significant interactions between taxpayers and tax authorities, and between the tax authorities themselves through the treaty-based MAP. In many cases, particularly complex cases involving the allocation of profits relating to hard-to-value intangibles, jurisdictions reach an agreement on the interpretation of facts and the application of the most reliable transfer pricing method such that they share profits in a fair and reasonable manner, or they agree to some other form of dispute resolution such as arbitration.[91]

In this context, the Commission's approach in the State Aid Cases raises serious concerns about the ability of EU Member States to honor their obligations under bilateral tax treaties with the United States, and with any other tax treaty partner. When a Member State tax authority makes a transfer pricing adjustment with respect to a resident company, the United States expects that if a related and negatively impacted U.S. company believed that such adjustment constituted taxation not in accordance with the provisions of the bilateral tax treaty between the United States and the relevant Member State, that U.S. company would be entitled to seek assistance under the MAP provisions of the relevant tax treaty, and the United States and the relevant national tax authority would be obligated to endeavor to resolve the dispute. However, potential Commission intervention creates a lack of certainty in MAP that, if not carefully managed, could upend treaty relations between Member States and their treaty partners, such as the United States.

There remains the possibility of resorting to MAP with the Member State in regard to a Commission decision on State aid, but such Member State would presumably be unable to provide relief without further violating EU law.[92] Furthermore, even if the Commission ultimately provided detailed guidance on what, in its view, constitutes an arm's length price, such guidance is not incorporated into any treaty or other instrument to be used as a normative framework for resolving disputes. In contrast to the OECD TP Guidelines, no country will have played a role in developing the Commission's guidance, which also would not be incorporated into bilateral tax treaties between the United States and Member States. This will inevitably lead to disputes that are unresolvable through MAP, resulting in potential double taxation.

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[91] The U.S. Treasury Department has been a strong proponent of binding mandatory arbitration to more efficiently resolve disputes, and has worked with a group of countries, including Belgium, Ireland, Luxembourg, and the Netherlands, over the past year on developing a multilateral instrument to incorporate it into existing treaties. Any treaty obligations to resolve transfer pricing disputes including through arbitration may be undermined if the resolution of disputes regarding State aid adjustments can be effectively overruled by the Commission.

[92] Moreover, as we understand EU law, a Member State is not required to collect a State aid adjustment through the tax system, but must recover the adjustment from the entity that the Commission determined to have received State aid. If the amount is not recovered as an "income tax" within the meaning of bilateral tax treaties, but is nonetheless based on the Commission's determination of an arm's length price, the provisions of the Member State treaty (which generally applies only to income taxes) can be circumvented altogether, a situation entirely at odds with the G20-endorsed BEPS work on mutual agreement procedures.

D. The Investigations Undermine Progress Made Under the BEPS Project

The U.S. Treasury Department understands and shares the Commission's strong interest in preventing multinational companies from achieving double non-taxation. But the Commission's new interpretation of State aid doctrine threatens to undermine the well-established basis of mutual cooperation and respect that many countries have worked hard to develop and preserve, particularly in connection with the BEPS project.[93]

For decades, the international tax system has relied on the major economies' embrace of a set of carefully developed rules to allocate income among sovereign countries in a reasonable, broadly accepted manner, thereby minimizing the possibility of double taxation. In light of the increase in double *non*-taxation, the international community embarked on the BEPS project to reform the existing international tax architecture. After several years of negotiation and compromise, this project achieved consensus on a broad set of measures aimed at international corporate tax avoidance. Countries and companies around the world are responding by reforming their policies and behavior. This has all been done in a spirit of mutual cooperation without seeking retroactive recoveries like those being proposed by the Commission in the State Aid Cases.

If continued, the Commission's approach in the State Aid Cases will undermine years of careful negotiations and compromise among OECD members as part of developing the OECD TP Guidelines, particularly as they relate to intellectual property. Nearly all of the largest transfer pricing disputes in terms of revenue relate to intangibles such as intellectual property, which is by far the most contentious and difficult area of transfer pricing.

The countries participating in the BEPS project spent several years intensely negotiating revisions of the OECD TP Guidelines chapter on intangibles to establish a clear framework for determining the arm's length compensation due for the development, enhancement, maintenance, protection, and exploitation of intangibles and for the assumption of risks or contribution of assets related to such intangibles. The Commission's decision not to apply the arm's length principle based on OECD TP Guidelines but rather on its own set of standards diminishes the OECD's work and calls into question the validity of Member States' statements, made in connection with their participation in the OECD, that they would adhere to the OECD TP

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[93] In contrast, the Commission has appeared to take a much different approach to patent box regimes. In March 2014, the Commission announced an inquiry into both tax ruling practices and patent box regimes. *See* Commission Press Release IP/14/309, *State aid: Commission orders Luxembourg to deliver information on tax practices* (Mar. 24, 2014). But while the investigation of tax rulings led to the State Aid Cases, it appears that the Commission deferred its investigations into patent box regimes in order to allow Member States and the OECD to achieve a political solution. *See* Christiana HJI Panayi, *Advanced Issues in International and European Tax Law* 200 (2015); Matthew Newman, *EU Puts 'Patent Box' Probe on Hold, Official Says*, MLex, Nov. 5, 2015. As part of the BEPS project, the OECD in October 2015 approved the "modified nexus" approach as a minimum standard for patent boxes, while allowing a generous grandfathering period for non-compliant regimes. The EU's Code of Conduct Group subsequently adopted the OECD approach. Despite its March 2014 announcement, to date the Commission has not announced any investigations of patent box regimes.

Guidelines. It also calls into question the Commission's endorsement, as part of the G20, of the BEPS project and its outputs.

In the State Aid Cases, the Commission is charting a course that sets aside years of multilateral efforts to develop workable transfer pricing rules and combat BEPS—an effort that can succeed only if pursued multilaterally. The Commission's path runs the risk of the EU being perceived as having used its unique structure to undermine and reverse international progress on this important issue.

V. Conclusion

The U.S. Treasury Department continues to consider potential responses should the Commission continue its present course. A strongly preferred and mutually beneficial outcome would be a return to the system and practice of international tax cooperation that has long fostered cross-border investment between the United States and EU Member States. The U.S. Treasury Department remains ready and willing to continue to collaborate with the Commission on the important work of ensuring that the international tax system is fair, efficient, and predictable.