

DG COMPETITION WORKING PAPER ON STATE AID AND TAX RULINGS

Introduction

- (1) A measure by which the public authorities grant certain undertakings a favourable tax treatment which places them in a more favourable financial position than other taxpayers amounts to State aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU).¹ Since 1958, the Member States of the European Union are obliged to inform the European Commission of any plans to grant State aid and the Commission has the responsibility to assess whether measures notified by the Member States to it constitute State aid and, if so, whether those measures can be deemed compatible with the internal market.
- (2) While the Member States enjoy fiscal autonomy in the design of their direct taxation systems, any fiscal measure a Member State adopts must comply with the EU State aid rules, which bind the Member States and enjoy primacy over their domestic legislation.² As early as 1974, the Court of Justice of the European Union clarified that the Commission's competence in the field of State aid control also covers the area of direct business taxation.³ As a rule, fiscal measures of a general nature that apply to all undertakings without distinction fall within the remit of the Member States' fiscal autonomy and cannot constitute State aid, since they do not selectively advantage certain undertakings over others. By contrast, fiscal measures that discriminate between taxpayers in a similar factual and legal situation constitute, in principle, State aid.⁴
- (3) In 1998, the Commission adopted a Notice on the application of the State aid rules to measures relating to direct business taxation,⁵ which also covers discretionary administrative practices. More specifically, since 2001 the Commission has conducted a series of investigations into Member States' fiscal schemes that appeared to benefit only certain companies. Since then, the Commission has adopted a series of negative decisions finding such schemes to selectively advantage multinational companies. These decisions have *inter alia*, concerned national schemes that accept multinational corporations pricing their intra-group transactions in a manner that does not reflect the conditions that apply between independent companies at arm's length.⁶ This "arm's length principle" aims to ensure that all economic operators are treated in the same

¹ Case C-105/14 *Taricco and Others* EU:C:2015:555, paragraph 61; Case C-6/12 *P Oy* EU:C:2013:525, paragraph 18; Joined Cases C-106/09 P and C-107/09 P *Commission and Spain v Government of Gibraltar and United Kingdom*, paragraphs 72 and 73; Joined Cases C-78/08 to C-80/08 *Paint Graphos and Others* EU:C:2009:417, paragraph 46; and Case C-387/92 *Banco Exterior de España* EU:C:1994:100, paragraph 14.

² See Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL v. Commission* EU:C:2006:416, paragraph 81; Joined Cases C-106/09 P and C-107/09 P *Commission v Government of Gibraltar and United Kingdom* EU:C:2011:732; Case C-417/10 *3M Italia* EU:C:2012:184, paragraph 25, and Order in Case C-529/10 *Safilo* EU:C:2012:188, paragraph 18; See also Case T-538/11 *Belgium v. Commission*, EU:T:2015:188, paragraph 66.

³ Case 173/73 *Italy v Commission* EU:C:1974:71.

⁴ Case C-6/12 *P Oy* EU:C:2013:525, paragraph 18 and the case-law cited.

⁵ OJ 1998 C 384, p. 3; this Notice was recently repealed and replaced by the Commission Notice on the Notion of State aid as referred to in Article 107(1) TFEU, which was adopted on 19 May 2016.

⁶ See, for example, Commission Decision of 22 August 2002 in Case C 48/2001 (ex NN 43/2000) *on the aid scheme implemented by Spain in favour of coordination centres in Vizcaya*, OJ L 31, 6.2.2003, p.26; Commission Decision of 5 September 2002 *on the aid scheme implemented by Germany for control and coordination centres*, OJ L 177, 16.7.2003, p. 17; Commission decision of 16 October 2002 on the State aid scheme C 49/2001 (ex NN 46/2000) - *Coordination Centres - implemented by Luxembourg*, OJ L 170, 9.7.2003, p. 20, paragraph 53; and Commission Decision of 17 February 2003 *on the aid scheme implemented by Belgium for coordination centres established in Belgium*, OJ L 282, 30.10.2003, p. 25.

- manner when determining their taxable base for corporate income tax purposes, regardless of whether they form part of an integrated corporate group or operate as standalone companies on the market.
- (4) In 2006, the European Court of Justice endorsed the arm's length principle for determining whether a fiscal measure prescribing a method for an integrated group company to determine its taxable profit gives rise to a selective advantage for the purposes of Article 107(1) TFEU.⁷ Accordingly, a fiscal measure that endorses a method for determining an integrated group company's taxable profit in a manner that does not result in a reliable approximation of a market-based outcome in line with the arm's length principle can confer a selective advantage upon its recipient. That would be the case where such a fiscal measure results in a reduced taxable profit, and thus reduced corporate income tax liability.
 - (5) The Commission does not call into question the granting of tax rulings by the tax administrations of the Member States. It recognises the importance of advance rulings as a tool to provide legal certainty to taxpayers. Provided they do not grant a selective advantage to specific economic operators, tax rulings do not raise issues under EU State aid law. Since 2013, the Commission's Directorate-General for Competition (DG Competition) has been carrying out an inquiry into tax ruling practices from this perspective of EU State aid rules.
 - (6) By the end of 2014, all Member States had been asked to provide information about their tax ruling practice and the legal framework underlying that practice, as well as a list of tax rulings issued in the years 2010 to 2012 (and partly 2013). On the basis of this information, DG Competition requested specific tax rulings. Overall, DG Competition has looked at more than 1,000 tax rulings.⁸
 - (7) The inquiry has focussed, in particular, on tax rulings which endorse transfer pricing arrangements proposed by the taxpayer for determining the taxable basis of an integrated group company. Transfer prices refer to the prices charged for intra-group transactions concerning the sale of goods or services between associated group companies. The Commission has also analysed "confirmatory rulings", which confirm the application, or the non-application, of a certain legislative provision to a specific situation.⁹
 - (8) The inquiry led, in mid-2014, to the opening of three formal State aid investigations by the Commission on tax rulings granted by Ireland (to Apple)¹⁰, Luxembourg (to Fiat)¹¹ and the Netherlands (to Starbucks)¹². Further investigations were opened by the Commission later the same year and in 2015 on tax rulings granted by Luxembourg (to Amazon¹³ and to McDonald's¹⁴) and by Belgium (the Excess Profit scheme¹⁵). At the

⁷ Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL v. Commission* EU:C:2006:416.

⁸ Including about 600 tax rulings which appeared in the public domain in November 2014 ("LuxLeaks").

⁹ For example, a ruling can confirm that a company has a branch, which means that the company will in principle be taxable in the jurisdiction of that branch.

¹⁰ Commission Decision of 11 June 2014, Case SA.38373 *Alleged aid to Apple*, available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38373.

¹¹ Commission Decision of 11 June 2014, Case SA.38375 *Alleged aid to FFT*, Decision of 11 June 2014 available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38375.

¹² Commission Decision of 11 June 2014, Case SA.38374 *Alleged aid to Starbucks*, Decision of 11 June 2014 available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38374.

¹³ Commission Decision of 7 October 2014, Case SA.38944 *Alleged aid to Amazon*, available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38944.

¹⁴ Commission Decision of 3 December 2015, Case SA.38945 *Alleged aid to McDonald's*, not yet published, see IP/15/6221 available at http://europa.eu/rapid/press-release_IP-15-6221_en.htm.

end of 2015 and the beginning of 2016, the Commission adopted three negative decisions with recovery with respect to the tax ruling granted by the Netherlands to Starbucks,¹⁶ the tax ruling granted by Luxembourg to Fiat¹⁷ and the Excess Profit Scheme in Belgium.¹⁸ Those decisions provide further guidance to Member States' tax administrations and multinational corporate groups on how the Commission applies the EU State aid rules in this field. The Commission is continuing its investigations concerning the tax treatment of Apple by Ireland, and Amazon and McDonald's by Luxembourg. It will open further investigations if it has serious reasons to consider that State aid may have been granted by way of a tax ruling in other cases.

- (9) The inquiry has provided DG Competition with a first overview of the tax ruling practice of the Member States and of tax planning strategies utilised by integrated corporate groups.
- (10) This working paper of DG Competition aims to provide a short summary of its preliminary orientations. It does not bind the Commission and is without prejudice to any further cases the Commission may open.

Preliminary findings of the ruling investigation with respect to transfer pricing rulings

Different Member States' practices

- (11) The tax ruling practices of the Member States differ significantly in **quantitative terms** over the period investigated. Some Member States have issued thousands of rulings to economic operators every year, among which many are transfer pricing rulings. By contrast, five Member States (Bulgaria, Croatia, Latvia, Greece and Slovenia) have informed the Commission that they did not grant any transfer pricing rulings during the period under investigation.
- (12) In terms of the **procedure**, most Member States follow closely the procedural guidance provided by the EU¹⁹ and the Organisation for Economic Co-operation and Development (OECD) for granting a transfer pricing ruling. In particular, a majority of tax administrations systematically require ruling requests to be accompanied by transfer pricing reports to substantiate the choice of a transfer pricing method and the arm's length nature.

Tax rulings: how to approximate market prices

- (13) A considerable number of the rulings relate to transfer pricing arrangements that appear to reflect a reliable approximation of a market based outcome in line with the arm's length principle. In general, rulings that cover intra-group transactions between two different Member States, where both companies carry out genuine economic activities on which they are taxed, have been found to be unproblematic.
- (14) However, some transfer pricing arrangements do not seem to reflect the arm's length principle when the outcome manifestly deviates from a reliable approximation of a market based outcome.

¹⁵ Commission Decision of 3 February 2015, Case SA.37667 *Excess profit tax ruling system in Belgium* available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_37667.

¹⁶ Commission Decision of 21 October 2015, Case SA.38374 *Aid to Starbucks*, not yet published.

¹⁷ Commission Decision of 21 October 2015, Case SA.38375 *Aid to Fiat*, not yet published.

¹⁸ Commission Decision of 11 January 2016, Case SA.37667 *Excess profit tax ruling system in Belgium*, available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_37667.

¹⁹ See e.g. Commission Communication on Advance Pricing Agreements (COM (2007) 71 final), which in its Annex specifies the required documents for transfer pricing rulings.

- (15) This concerns, for example, a number of tax rulings regarding the remuneration of **financing companies** that are part of group companies. The only activity of such financing companies is the passing-on of funds or intellectual property (IP) rights from one group company to another. In some Member States with no withholding tax, there are tax rulings approving profit margins for these financing companies. In a Commission decision of 2002, a scheme previously operated by Luxembourg setting out such margins at 12.5 basis points of the loan amount was qualified as incompatible State aid.²⁰ By way of example, and without prejudice to a case-by-case assessment, the taxable profit of the financing company is still determined in these rulings in a uniform manner as a margin of the underlying transaction, without a clear economic analysis. Under such rulings, the company taking the loan can typically deduct the full interest payment from its taxable income, while the group financing company receiving the interest payment is taxed only on this margin, which represents a fraction of the overall interest received on this loan.
- (16) Another example are rulings which endorse **tax deductions for payments** or charges between group companies, even where such payments are not actually made. Without prejudice to a case by case analysis, such virtual payments seem possible only in a group context and not between independent companies transacting on the market at arm's length.
- (17) As regards selecting the most appropriate **transfer pricing method**, the OECD's Transfer Pricing Guidelines²¹ describe five methods to approximate an arm's length pricing of transactions between companies of the same corporate group: (i) the comparable uncontrolled price method (CUP); (ii) the cost plus method; (iii) the resale minus method; (iv) the transaction net margin method (TNMM) and (v) the transactional profit split method. The OECD Guidelines draw a distinction between traditional transaction methods (the first three methods) and transactional profit methods (the last two methods) and declare a preference for traditional transaction methods, such as the CUP, over transactional methods, such as the TNMM, as a means to establish whether transfer pricing is at arm's length.²² Those guidelines further explain that multinational corporations retain the freedom to apply methods not described in those Guidelines to establish transfer prices, provided those prices satisfy the arm's length principle.
- (18) As set out in the Commission Notice on the Notion of State aid, the OECD Guidelines *"provide useful guidance to tax administrations and multinational enterprises on how to ensure that a transfer pricing methodology produces an outcome in line with market conditions. Consequently, if a transfer pricing arrangement complies with the guidance provided by the OECD Transfer Pricing Guidelines, including the guidance on the choice of the most appropriate method and leading to a reliable approximation of a market based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State aid."*²³
- (19) Furthermore, the inquiry suggests that the use of certain transfer pricing methods provides a more reliable means to approximate a market based outcome than others. In

²⁰ Case C 50/01 Commission Decision of 16 October 2002 *Finance Companies Luxembourg*, OJ 2003 L 153, p. 40.

²¹ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 22 July 2010.

²² Paragraph 2.3 of the 2010 OECD Guidelines provides: *"As a result, where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method."*

²³ Commission Notice on the Notion of State aid as referred to in Article 107(1) TFEU, paragraph 173.

particular, the CUP method sets prices for intragroup transactions by making direct comparisons with the price charged on the market for the same goods or services. However, in some cases, a ruling is based on the CUP method without any comparables being presented. In such situations, the use of the CUP method may not result in a reliable approximation of a market-based outcome in line with the arm's length principle.

- (20) Some rulings are based on a **two-sided approach**, i.e. both companies to the intra-group transaction are analysed, where there is less room to deviate from a market outcome. This is, in particular, the case for the profit split method, where both sides of the transaction are allocated a share of the overall profit. The profit split method does not rely on a reference to comparable transactions in the market but will, if applied consistently by all jurisdictions involved, divide the full amount of profits between the two companies to the intra-group transaction. A two-sided approach is also in principle required in case of Bilateral Advance Pricing Agreements (BAPAs), where two countries accept a transfer pricing arrangement between group companies in these two countries.
- (21) Other rulings are based on a **one-sided approach**, which determines the remuneration of only one party to the intra-group transaction, namely the taxpayer requesting the ruling. In practice, this refers to rulings endorsing a transfer pricing arrangement based on the TNMM. This type of transfer pricing arrangement generally determines the remuneration of that company based on its activity or function performed.²⁴ Based on that determination, the remaining profit (the residual profit) is automatically allocated by that company to another company in another tax jurisdiction, sometimes without any information about the activities of that other company. This method is often used when the group company located in the other tax jurisdiction holds IP.
- (22) Where the TNMM is used, operating expenses are often retained when the taxable base is determined as a mark-up on a **performance indicator**.²⁵ 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.²⁶ An appropriate indicator is the one that best captures the commercial value of the activity.
- (23) The approximate nature of the arm's length principle cannot be used to justify a transfer pricing analysis that is either methodologically inconsistent or based on an inadequate comparables selection. There are cases where finding a market outcome is not straightforward and requires the use of an approximation. This is not a concern as such, as long as the approximation is as precise as it can be under the circumstances. In other words, the *"search for a 'reliable approximation of a market-based outcome' means that any deviation from the best estimate of a market-based outcome must be limited and proportionate to the uncertainty inherent in the transfer pricing method chosen or the statistical tools employed for that approximation exercise."*²⁷ Against this background,

²⁴ Commission Decision of 21 October 2015, Case SA.38375 *Alleged aid to FFT*, op cit. Commission Decision of 21 October 2015, Case SA.38374 *Alleged aid to Starbucks*, op cit., Commission Decision of 11 January 2016, Case SA.37667 *Excess profit tax ruling system in Belgium*.

²⁵ The performance indicator is defined as the ratio of pre-tax profits to operating expense.

²⁶ A more appropriate indicator in those cases could be return on sales or return on equity. In Commission Decision of 21 October 2015 in Case SA.38375 *Alleged aid to FFT*, op cit., paragraph 247, the Commission accepted the use of the TNMM method and that a return on equity was an appropriate indicator as the company was engaging in genuine financing activity.

²⁷ Commission Notice on the Notion of State aid as referred to in Article 107(1) TFEU, adopted on 19 May 2016, paragraph 171.

DG Competition's focus is on cases where there is a **manifest breach** of the arm's length principle.

Conclusion

- (24) State aid control in tax rulings follows from the Commission's competence in the field of State aid as set out in the EU Treaties to investigate cases under State aid rules with the objective to prevent distortions of competition through the granting of special tax advantages that are not available to all similarly situated taxpayers in a given Member State.