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Case Notes

Starbucks and *Fiat Chrysler*: is the European Commission defending national tax regimes?

The judgments in *Netherlands (supported by Ireland intervening) v European Commission; Starbucks Corp and another v European Commission* (*Starbucks*)[1] and *Luxembourg (supported by Ireland intervening) v European Commission; Fiat Chrysler Finance Europe (supported by Ireland intervening) v European Commission* (*Fiat Chrysler*)[2] have been eagerly awaited by a wide range of interested parties. Both the factual background and the legal implications are extensive. The very limited review of them which is possible here is intended to provide a base from which to take an overview of the litigation and some of the most important questions which it raises. For example, do these cases question the scope of the powers of Member States in relation to tax or is it merely the proper application of the domestic tax rules which is being addressed? In addition, one may ask if the arm's length principle in tax, the credibility of which is currently under a certain amount of pressure, is comparable to relevant principles in state aid law. One may also ask if it is appropriate to conflate arm's length transactions with commercial transactions.

Both the UK and Ireland had to consider the subsidiary issue of whether or not to intervene in the litigation. The two states came to different conclusions. In doing so they made choices which reflect their different political positions and aspirations. Whether, with hindsight, they will be content with their respective positions remains to be seen.

The judgments shine an unusually bright and, perhaps, uncomfortable light upon the activities of corporate taxpayers and national tax administrations and the relationship between them. The European Commission, controller of the state aid search light, has had the task of interpreting what it has discovered in a territory which it has only relatively recently begun to explore. Some will think that its reaction to unfamiliar terrain, while understandable, will need to exhibit more sophistication in the future. Member States meanwhile, have reacted unenthusiastically, and on some occasions with undisguised concern, to the activities of strangers to the land of national tax administration.

The Commission's decisions that the tax rulings of the authorities in the Netherlands and Luxembourg gave rise to state aid were both given on 21 October 2015.[3] The General Court judges hearing the challenges to both the Commission's decisions were sitting in an identically

[1] *Netherlands (supported by Ireland intervening) v European Commission; Starbucks Corp and another v European Commission* (Joined Cases T-760/15 and T-636/16) EU:T:2019:669; [2019] STC 2323.

[2] *Luxembourg (supported by Ireland intervening) v European Commission; Fiat Chrysler Finance Europe (supported by Ireland intervening) v European Commission* (Joined Cases T-755/15 and T-759/15) EU:T:2019:670; [2019] STC 2416.

[3] Commission Decision 2017/502/EU of October 21 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks [2017] OJ L83/38 and Commission Decision 2016/2326/EU of October 21 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat [2016] OJ L351/1.

constituted seventh chamber with extended composition. Ireland supported the Netherlands, Luxembourg and Fiat Chrysler Finance Europe. The Court decisions were both delivered on 24 September 2019. Thereafter the course of the two sets of proceedings diverge. The Commission's decision in relation to the Netherlands was annulled whereas its decision in relation to Luxembourg was upheld. Only the decision in relation to Luxembourg has been appealed.[4]

Some basic facts: *Starbucks*

Starbucks concerned an advance pricing arrangement (APA) entered into by the Netherlands' tax authorities on 28 April 2008. It was valid for the period 1 October 2007 to 31 December 2017. In contrast, Fiat Chrysler concerned a tax ruling made on 3 September 2012 which was to be valid for the five tax years, 2012 to 2016. At first sight, one may think that the longer ruling would be the most vulnerable. In fact, the opposite turned out to be the case.

The *Starbucks* APA concerned Starbucks Manufacturing Emea BV (SMBV) which was established in the Netherlands. It was a subsidiary of the Starbucks group the controlling company of which had its headquarters in Seattle. SMBV was mainly responsible for the production of roasted coffee beans and their provision, along with related products, to Starbucks' shops in Europe, the Middle East and Africa (the EMEA region). It had a roasting facility in the Netherlands.

SMBV paid a royalty to Alki LP (Alki). Alki was another subsidiary of the Starbucks group. It was established in the UK and indirectly controlled SMBV. The royalty was paid by SMBV for the use of Alki's intellectual property in respect of roasting technologies and roasting know-how.

The APA was established for the purposes of SMBV's corporate income tax declarations in the Netherlands. Article 8b(1) of the Law on Corporation Tax[5] imposed an arm's length standard where one entity participated directly or indirectly in the management, control or capital of another entity and the conditions between these entities differed from those which would have been made between independent parties. In such circumstances the profit of the entities is to be determined as if the conditions were those which would have been made between independent parties.[6]

The APA aimed to establish SMBV's remuneration for its production and distribution activities within the Starbucks group using the arm's length method. It also endorsed the amount of the royalty to be paid. The royalty was calculated according to the transactional net margin method (TNMM). The Commission used the comparable uncontrolled price (CUP) method to analyse it. As is well known, both methods are included amongst the methods permitted under the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995–2013) (the Guidelines) which aim to assist enterprises and administrations in their application of the arm's length principle authoritatively stated in Article 9.1 of the OECD's *Model Tax Convention on Income and on Capital*.

[4] See *Ireland v Commission and others* (C-898/19 P) and *Fiat Chrysler Finance Europe v Commission* (C-885/19 P).
[5] Law on Corporation Tax (*Wet op vennootschapsbelasting*) 1969.
[6] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [4].

By the decision of 21 October 2015 the Commission found that the APA constituted aid incompatible with the internal market and Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), and ordered the recovery of €25.7 million. It considered that the royalty paid was not a reliable approximation of a market-based outcome and would not have resulted from negotiations between independent undertakings negotiating in comparable circumstances. Consequently, SMBV obtained a selective advantage.

Some basic facts: *Fiat Chrysler*

Fiat Finance and Trade Ltd (FFTL), based in Luxembourg, provided treasury services and financing to the companies of the Fiat/Chrysler automobile group established in Europe. The Luxembourg tax code and a circular issued by the director of Luxembourg taxes ensured that an arm's length principle was part of Luxembourg's tax law.[7] It required transactions between group companies to be taxed as if they had been agreed to by independent companies negotiating under comparable circumstances at arm's length. The tax ruling in issue endorsed a method for arriving at a profit allocation to FFTL within the Fiat/Chrysler group so as to establish its yearly corporate income tax liability to Luxembourg.

The allocation was established using the TNMM and the profit attributed to FFTL had a risk remuneration element and a functions remuneration element. There was no remuneration in respect of FFTL's equity designated as supporting its equity in two companies outside Europe. By its decision, the Commission found that the ruling constituted operating aid incompatible with the internal market and Article 107(1) TFEU and ordered recovery of the aid.

In coming to its conclusion, the Commission rejected the use of the TNMM and a number of aspects of the methodology used in the relevant analysis. For example, it considered the use of the hypothetical regulatory capital of FFTL to be both inappropriate and underestimated the return on such capital out of line with the arm's length principle. The Commission concluded that the tax ruling in issue had conferred a selective advantage on FFTL. It had resulted in a tax liability which was lower than that of stand-alone companies under Luxembourg's corporate income tax system. The liability was also lower than that under the regime applicable to integrated companies.

Starbucks and the General Court: a detailed attack succeeds

The General Court annulled in its entirety the decision of the European Commission in relation to the ruling by the Netherlands' tax authorities. It concluded that the reasoning of the Commission in the decision had not demonstrated the APA had conferred on SMBV an "advantage" within Article 107 TFEU. It followed that the Commission had not demonstrated, as it had to do, that the ruling derogated from the law on corporate income tax and the relevant transfer pricing decree, so that less tax was paid than would otherwise have been the case.

The Commission had committed numerous errors. It had wrongly concluded that the mere choice of the use of the TNMM resulted in an advantage,[8] wrongly based its analysis on

[7] See Luxembourg Income Tax Code of December 4, 1967, Art.164(3) and Circular L.I.R. No 164/2 of January 28, 2011 issued by the director of Luxembourg taxes.
[8] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [216].

information that was not available or reasonably foreseeable in April 2008 when the APA had been entered into,[9] incorrectly concluded that SMBV did not need to pay a royalty,[10] and failed to demonstrate that SMBV had made a loss on its roasting activities since 2010 so making the payment of royalty impermissible.[11] Furthermore, there were a number of criticisms to be made of the analysis of the comparability of relations between SMBV and Alki and the Starbucks group and third parties.[12] In particular, the Commission was wrong to assert that analysis of the group and third parties would have shown that, using the CUP, there would have been no royalty payment passing between the two companies in question.[13]

The catalogue of errors continued. The Commission made errors in saying that the royalty should have been less than that affirmed under the APA[14] and went wrong in its consideration of the appropriate mark-up for coffee beans.[15] The Court said that the Commission's attempt to replicate the tax adviser's analysis of SMBV's position with that of a corrected peer group of companies "first, lacks reliability, and, second is vitiated by a number of errors".[16] One of those errors involved comparing the incomparable, namely, the operating profits of comparable companies with the taxable profits of SMBV.[17] Furthermore, adjustments by the Commission made to ensure appropriate comparability between SMBV and other companies could not be justified.[18]

It is hardly surprising that the General Court's judgment in *Starbucks* is not being appealed. Margrethe Vestager Executive Vice-President of the European Commission expressly confirmed the position on 27 November 2019.[19]

By concentrating on the details of the Commission's analysis, the Netherlands managed to undermine the Court's confidence in it. That is often the best approach to challenging decisions of the Commission. Anyone used to attacking decisions to impose anti-dumping duty, for example, will have had the same experience. Those decisions too require a detailed prior investigation. If the detailed prior investigation can be shown to be inadequate the subsequent decision falls. High-flown attacks involving matters of political significance may appear more attractive. In reality, a court is much more likely to accede to a case which is founded on tightly defined issues of technical competence.

That is not to say that the Netherlands did not raise more general matters, it did. Like Luxembourg it alleged improper tax harmonisation by the Commission. The Court repeated some general observations about EU law and tax which will be regarded as important by Member

[9] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [251].
[10] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [265].
[11] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [278].
[12] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [288]–[345].
[13] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [346].
[14] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [372].
[15] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [402].
[16] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [500].
[17] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [493].
[18] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [548].
[19] L. Crofts and N. Hirst, *Starbucks' EU court victory on tax bill to go unchallenged, Vestager says* (MLex, 2019), available at: *https://mlexmarketinsight.com/insights-center/editors-picks/antitrust/europe/starbucks-eu-court-victory-on-tax-bill-to-go-unchallenged-vestager-says* [Accessed 15 January 2020].

States.[20] The Commission, on the other hand, will note that the Court concluded that it could use the arm's length principle in an investigation under Article 107(1) TFEU.[21] Nevertheless, the Commission could not be taken to have said in its decision that there was a general principle of equal treatment in relation to tax inherent in Article 107(1) TFEU. That would give that article "too broad a scope".[22]

In an observation which may well come to be significant in future cases, the Court acknowledged that the Commission is to give Member States a margin of appreciation in relation to their tax systems. It said

> "where the Commission checks whether the taxable profit of an integrated undertaking in application of a tax measure corresponds to a reliable approximation of a taxable profit realised under market conditions, it may determine the existence of an advantage within the meaning of art 107(1) TFEU only provided that the discrepancy between the two factors goes beyond inaccuracies inherent to the method used to obtain that approximation".[23]

In all the circumstances the provision of such a margin of discretion is inevitable. Its existence is an acknowledgement that the comparative exercise which the Commission undertakes in cases concerning a tax ruling is far from precise. The application of the arm's length rule is necessarily an exercise in approximation. Precise numbers are frequently used in imprecise ways.

Fiat Chrysler and the General Court: a more general attack fails

Like the Netherlands, Luxembourg contended that the Commission was engaging in tax harmonisation in disguise. In addition it relied upon the division of competences between Member States and the EU and the principle that the Commission has only those powers which are conferred upon it.[24]

The General Court made it clear that the Commission was not engaging in tax harmonisation. As may have been expected it re-stated the basic proposition that

> "since the Commission has the power to monitor compliance with Article 107 TFEU, it cannot be accused of having exceeded its powers when it examined the tax ruling at issue in order to determine whether it constituted State aid and, if it did, whether it was compatible with the internal market, within the meaning of Article 107(1) TFEU".[25]

The Court also accepted that direct taxation falls within the competence of Member States. In doing so it used a formulation which is familiar to anyone who has read any decision of the Court of Justice concerning the application of the fundamental freedoms to national tax law, namely

[20] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [143] and [158].
[21] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [163].
[22] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [168].
[23] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [498] and [512].
[24] Reliance was placed on the Treaty on European Union Arts 3(6), 4, 5(1) and 5(2). See the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [100] and [101].
[25] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [107].

> "according to settled case-law, while direct taxation, as EU law currently stands, falls within the competence of the Member States, they must nonetheless exercise that competence consistently with EU law…".[26]

Dealing with matters more specifically linked to state aid law, Member States, including Ireland no doubt, will have been pleased to see that the Court accepted that:

> "the Commission does not, at this stage of the development of EU law, have the power autonomously to define the 'normal' taxation of an integrated undertaking, disregarding national tax rules".[27]

Luxembourg failed, however, to sustain its contention that the use of the arm's length principle constituted an infringement of its fiscal autonomy or that it breached the principles of legal certainty and the protection of legitimate expectations.[28] Other unsuccessful submissions related to the methodology of establishing state aid including the existence of an advantage and selectivity, the obligation to state reasons, the alleged failure of the Commission to engage in sufficient analysis of the competitive effect of the tax ruling[29] and the alleged breach of the principle of legal certainty in relation to recovery of the aid.[30]

Luxembourg did have, however, one area in which to make detailed submissions about the analysis of the Commission. It concerned, largely, the methodology for calculating the remuneration of FFTL and, in particular, the segmentation of its capital to which four out of five alleged errors were related.[31] The fifth error concerned the rate of return applied to the hypothetical regulatory capital.[32] These were all rejected by the Court. Consequently, the Commission was able to sustain its conclusion that the tax ruling conferred an advantage. Consequently, Luxembourg's further submissions denying the existence of an advantage were considered only for the sake of completeness.[33]

The weight of the Netherlands' attack on the technicalities of the Commission's investigation carried it to victory. Luxembourg in contrast may be thought to have advanced a somewhat more limited technical attack (which is not to say it will necessarily be unsuccessful on appeal). As the Commission is not appealing the decision in relation to *Starbucks* that appeal is of considerable significance. For the Commission to lose the appeal in *Fiat Chrysler* would be the worst possible start to its attempt to apply state aid law to tax rulings. All Member States will be watching what happens carefully. So too will one country which is no longer a Member State, namely, the UK.

To intervene or not: the UK and Ireland

Given their attitude to the taxation of companies, it is no surprise that Ireland and the UK intervened in both cases. They were granted leave to intervene in *Starbucks* on 25 May 2016

[26] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [104].
[27] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [112].
[28] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [126].
[29] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [398].
[30] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [399] onwards.
[31] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [193].
[32] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [194].
[33] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [287].

and in *Fiat Chrysler* on 13 June 2016. On 9 November 2016, however, the UK withdrew its intervention in both cases. It may be that the UK, apparently like the great majority of EU Member States, thought that its interests were best served by not being associated with state aid cases concerning tax rulings in the Netherlands and Luxembourg. That may be an entirely supportable position. Had the UK taken that view, however, it would not have intervened in the first place.

The reason for withdrawal would seem more likely to be related to the fact that the UK had held its referendum on membership of the EU on 23 June 2016 and that there was a majority in favour of Brexit. If intervention could be justified before the referendum, however, it could certainly be justified afterwards, at least if the political declaration on the future of the EU/UK relationship of 17 October 2019, and subsequently amended, is to be regarded as significant.[34]

The political declaration, even in its renegotiated form, makes clear that, in future relations between the EU and the UK, distortions of trade and unfair competitive advantages should be prevented. Accordingly, it envisages the maintenance of common high standards in areas including state aid and relevant tax matters. In addition, the parties commit to the principles of good governance in taxation and the curbing of harmful tax practices. The declaration envisages a trade agreement which will give more than one possible ground for examination of the rulings of the UK's tax authorities.[35]

The calculation for Ireland in relation to its involvement in these cases is obviously somewhat different from that of the UK. These proceedings help to establish a regime to which Ireland and the Irish tax authorities will be subject in future. That is, of course, true also for the other Member States but Ireland may have particular sensitivities in relation to national tax policy. In those circumstances Ireland's decision to ally itself with Luxembourg is worth considering.

It is entirely understandable that Ireland may consider that the early cases in relation to tax rulings may establish a line of jurisprudence which could subsequently be applied in relation to its tax regime. Consequently, it may have been thought essential for Ireland to ensure that its views are acknowledged as early as possible in relevant litigation. Both judgments of the General Court, perhaps particularly the judgment in *Fiat Chrysler*, contain material which will be helpful to Member States who wish to preserve their sovereignty in tax matters. Two points, however, may usefully be kept in mind.

First, the history of the cases concerning the fundamental freedoms and national taxation shows that Member States have had relatively little success when they advance broad propositions to the effect that national tax systems are their business and theirs alone. Greater success has come when they have acknowledged the application of the fundamental freedoms to national taxation but have sought then to rely upon the details of the particular case before the Court to limit the effect of the freedoms. The respective results of the cases involving the Netherlands and Luxembourg may indicate a similar state of affairs in relation to state aid.

Secondly, the nature of the tax system which Luxembourg operated at the relevant time is not the same as the tax system which is in issue in Ireland in relation to Irish tax rulings. That is

[34] Political declaration setting out the framework for the future relationship between the European Union and the United Kingdom [2019] OJ C384 I/178 (12 November 2019). It is a revised version of the declaration published on 25 November 2018 which is available at [2019] OJ C66 I/185 (19 February 2019).
[35] See the revised political declaration, above fn.34, Pt II, s.XIV "Level playing field for open and fair competition", para.77.

true, in particular, so far as concerns the presence or absence of the arm's length principle in the two tax systems. There are specific considerations to be borne in mind in relation to the arm's length principle and taxation in Ireland. Consequently, in due course Ireland may well want to distance itself from Luxembourg rather than ally itself with it.

The "arm's length standard"—fallacious and commercial?

Throughout these cases the European Commission may appear to be posing as the advocate of the arm's length standard. It was the arm's length standard that it applied during the state aid investigations. It was the arm's length standard that formed part of the normal system of taxation against which the ruling and its effects were tested. Both the systems of taxation in the Netherlands and in Luxembourg expressly incorporated the arm's length standard. As was noted above, in the Netherlands that was achieved by article 8b(1) of the Law on Corporation Tax, referred to above. In Luxembourg it was achieved by Article 164(3) of the Luxembourg Income Tax Code[36] and Circular LIR No 164/2 of 28 January 2011[37] which was concerned with the remuneration of intra-group financing companies. Rather than see the Commission as applying an arm's length standard established independently of the respective tax systems one may read the cases as justifying the Commission ensuring the proper application of the arm's length principle in domestic tax law. Such activity is defending national tax law not distorting or developing it.

In considering the arm's length principle, the Court referred to material from the OECD including Article 9 of the Model Convention and the Guidelines as well as national law.[38] It also acknowledged that Article 107(1) TFEU permits the Commission to check whether the pricing of intra-group transactions corresponds to prices that would have been charged at arm's length where the normal national tax system itself provides that integrated companies are to be taxed on the same basis as stand-alone companies.[39] That is not the same as saying that an arm's length principle, as such, is part of EU law. Despite some possible lack of clarity as to the foundation of the arm's length principle, the CJEU did make clear that the arm's length principle was being applied in the context of the examination of a national tax measure.[40] That must always be borne in mind.

Notwithstanding the fact that the arm's length principle was part of the relevant national tax system, the EU courts are likely to find it helpful to be made aware of some of the difficulties which surround the arm's length principle in transfer pricing generally. The Court could, for example, be referred to material in Volume 102B of the *Cahiers de droit fiscal international* in relation to the future of transfer pricing.[41] The General Report of Sergio André Rocha notes that

[36] *Loi du 4 décembre 1967 concernant l'impôt sur le revenu* (Law of 4 December 1967 on income tax).
[37] Circular LIR No 164/2 of 28 January 2011.
[38] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [6] and [7] and *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [13]–[15].
[39] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [149]–[151] and the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [157].
[40] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [166] and the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [153].
[41] S.A. Rocha, *The future of transfer pricing – General Report, Cahiers de droit fiscal international* (2017), Vol.102B, 191.

originally the arm's length principle was based on three pillars.[42] First, there was the fiction of legal entities. Secondly, there was the relevance of contractual arrangements. Thirdly, there was the principle of the comparability of transactions. He then observes that "the foundations of these pillars are not as strong as expected".[43]

In relation to the comparability of transactions Professor Avi-Yonah is quoted as referring to

> "a fallacy that lies at the system's core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement…".[44]

The EU courts may also find it helpful to consider the debate over arm's length transactions and commercial transactions in the context of the law of the fundamental freedoms. In *Hornbach-Baumarkt AG v Finanzamt Landau* (*Hornbach-Baumarkt AG*)[45] the taxpayer company challenged an amendment to its tax liability imposed by the German tax administration. The tax authority based its amendment on the gratuitous provision of a comfort letter, provided to a bank by Hornbach-Baumarkt AG, in respect of the liabilities of certain related foreign companies established in the Netherlands. The law under which the amendment was made would not have applied if all the relevant companies were domestic companies.

The CJEU held that the legislation permitting the amendment was not contrary to the freedom of establishment so long as it permitted the resident taxpayer the opportunity to prove that the terms of the relevant facility were agreed for commercial reasons resulting from its status as a shareholder of the non-resident company. The Court noted in particular that

> "there may be a commercial justification by virtue of the fact that Hornbach-Baumarkt AG is a shareholder in the foreign group of companies, which would justify the conclusion of the transaction at issue…under terms that deviated from arm's-length terms".[46]

It had to be determined whether or not Hornbach-Baumarkt AG was in a position, without being subject to undue administrative constraints, to put forward elements attesting to a possible commercial justification

> "without it being precluded that economic reasons resulting from its position as a shareholder of the non-resident company might be taken into account in that regard".[47]

In allowing commercial reasons relating to the company's position as a shareholder to be taken into account, the CJEU was acknowledging that transactions between group companies are not exactly comparable to transactions between independent companies and that there may be commercial factors affecting intra-group relationships which do not exist in relations between unrelated companies. It would be wrong to say that the Court is acknowledging the fallacy to

[42] Rocha, above fn.41.
[43] See Rocha, above fn.41, 197.
[44] See Rocha, above fn.41, 198 quoting from R. Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation" (2010) 2(1) *World Tax Journal* 3, 8.
[45] *Hornbach-Baumarkt AG v Finanzamt Landau* (C-382/16) EU:C:2018:366; [2018] STC 1267.
[46] *Hornbach-Baumarkt AG* (C-382/16), above fn.45, [2018] STC 1267 at [56].
[47] *Hornbach-Baumarkt AG* (C-382/16), above fn.45, [2018] STC 1267 at [57].

which Professor Avi-Yonah referred, but it certainly is acknowledging that associated and independent companies are not in precisely the same positions.

The difficulty of analysing transactions between associated companies and the contrast between a commercial transaction and an arm's length transaction was relevant also in the *Thin Cap Group Litigation*.[48] It is not necessary to review that case in detail here. Suffice it to say that Arden LJ, dissenting in this respect from the approach of the other members of the Court of Appeal, noted that:

> "While it might be tempting to think that, if a transaction fails to meet a test of arm's length, it cannot be commercial, it is necessary to recall the jurisprudence of the court prior to *Thin Cap* and the context in which the question of what is commercial arises."[49]

Having examined the relevant jurisprudence, the learned judge concluded that the relevant UK tax regime in relation to thin capitalisation ought to have allowed the taxpayer the opportunity to show that the relevant transaction was on commercial terms, not just that it was on arm's length terms.[50] The comments of the Advocate General when the matter was before the CJEU are, also, worth keeping in mind. The Advocate General noted, when considering proportionality, that:

> "It must be possible for a taxpayer to show that, although the terms of its transaction were not arm's length, there were nonetheless genuine commercial reasons for the transaction other than obtaining a tax advantage."[51]

There is no need to add to the material used to refute the comparability analysis carried out in *Starbucks* but it may be useful in future for the CJEU to explore in even more detail the difficulties inherent in such an analysis.

The market operator tests and margins of appreciation

It is, of course, fundamental to the law of state aid that the activities of the state are to be judged against the activities of a private operator under normal market conditions. That is true whatever activity the state is involved in. It may be acting as an investor, a creditor, or a provider of goods and services.

Two comments may be made in the light of this. First, the two state aid cases concerning tax rulings which the Court has decided do not require there to be any comparison between the activities of the state and a private actor. Instead, the Commission is examining state responses to commercial activity and carrying out a comparison between the conduct of associated and independent companies. Was it perhaps the unfamiliarity of this activity, in this context, which led to the Commission's catalogue of errors in *Starbucks*?

[48] *Test Claimants in the Thin Cap Group Litigation v IRC* (*Thin Cap ECJ*) (C-524/04) EU:C:2007:161; [2007] STC 906 and *Test Claimants in the Thin Cap Group Litigation v R & C Commissioners* (*Thin Cap CA*) [2011] EWCA Civ 127; [2011] STC 738.
[49] *Thin Cap CA*, above fn.48, [2011] STC 738 at [94].
[50] *Thin Cap CA*, above fn.48, [2011] STC 738 at [104]–[105].
[51] *Thin Cap ECJ* (C-524/04), above fn.48, [2007] STC 906 at [67] of the Advocate General's Opinion.

Secondly, the fact that the Commission is examining state responses to commercial activity rather than carrying out a direct comparison between state and commercial activity confirms that the state should be given a margin of appreciation of some considerable breadth. As has already been noted, the Court is conscious that there is a degree of uncertainty contained within the arm's length standard itself.[52] States will, however, develop their own approaches to the application of that standard appropriate to their own particular tax system. That seems unlikely to be objectionable in principle so long as the approach that they adopt is adopted generally and consistently and not selectively.

Conclusion

These two cases on tax rulings have resulted in understandable concern by Member States that their powers in relation to their own tax systems are being constrained. They may well remain concerned over the use of the arm's length principle by the Commission and what may be regarded as some confusion over its foundation. There was a suggestion, for example, that the Commission was attempting, at the hearing of the cases, to change the basis of the arm's length principle which it had applied.[53] What is clear, however, is that both the national tax systems which the Commission analysed in these cases incorporated the arm's length principle in domestic law. That being so, it may be said that all that the Commission was doing in investigating the tax rulings was ensuring that the domestic tax rules were applied without giving rise to state aid. That will not necessarily be controversial.

Should the Commission want to take a more general approach it is likely to find that its position is much less easy to defend. For one thing, the deficiencies in the arm's length principle are increasingly being recognised. The OECD itself acknowledges in its recent BEPS related work that the alternative courses of action that are set out in its Programme of Work under Pillar One "all go beyond the arm's length principle and depart from the separate entity principle".[54]

Perhaps the Commission has a choice. It may frame its contentions in relation to tax rulings and state aid in such a way as to cast itself as defending the proper operation of national tax systems and their domestic rules. Alternatively, it may advance broader contentions which encourage the suggestion that it is applying an arm's length principle, which is at least substantially similar to the one derived from Article 9.1 of the OECD *Model Tax Convention on Income and on Capital*. Even the OECD now recognises the limitations of that principle. Any such choice ought not to be too difficult to make.

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[52] See fn.23 above and the quotation to which it relates.
[53] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [165] and the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [153].
[54] OECD, public consultation document, *Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019* (OECD, 2019), para.10, third bullet point.

Advance pricing agreements; Arm's length transactions; EU law; European Commission; Interveners; Luxembourg; Member States; Netherlands; State aid; Tax determinations