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# Transfer pricing and state aid: the unintended consequences of advance pricing agreements

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An advance pricing agreement (APA) is a formal arrangement between a tax authority and a multinational enterprise (MNE) in which the parties jointly agree on the MNE's transfer pricing methodology, estimated taxable income, and tax payments for a fixed period, thus reducing the likelihood of an income tax dispute. We argue that APAs, which were developed by governments to solve MNE-state problems in one realm (international taxation of related party transactions), have had unintended consequences for both parties due to the spillover impacts of APAs into other policy realms. We explore this argument in the European Union state aid cases where, in the context of competition policy, APAs can be viewed as hidden, discretionary policies that can be misused by lower-tier governments to attract or retain inward foreign direct investment by offering individual MNEs preferential tax treatment. Our paper contributes to this literature by analyzing the unintended consequences of APAs and recommending policy changes to reduce these negative spillovers.

**Keywords:** advance pricing agreement, state aid, transfer pricing, dispute settlement

## 1. Introduction

Relations between multinational enterprises (MNEs) and governments entered a new phase when, in February 2014, the European Commission (EC) notified three Member States that the Commission was launching investigations to determine whether their tax authorities had provided illegal state aid to an MNE through an advance pricing agreement (APA). The notified governments and MNEs were Ireland (Apple), the Netherlands (Starbucks), and Luxembourg (Fiat).

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An APA is an *ex ante* dispute settlement mechanism negotiated behind closed doors between an MNE and a tax administration (Byrnes and Cole, 2018; Eden, 1998; Markham, 2012). The purpose of an APA is to prevent tax disputes between the MNE and the tax authority by determining *ex ante* the MNE's transfer prices and taxable income, thus providing some certainty about the MNE's future tax payments. An APA is designed to be a neutral tax procedure that improves the overall process of determining an MNE's taxable income within and between tax jurisdictions.

The EC notifications argued, however, that these APAs had been used for a different purpose: to stretch the law and provide a tax benefit to a specific MNE by artificially lowering its taxable profits and its tax payments. A tax benefit received by a firm from a European Union (EU) Member State, if the benefit provides a specific and discriminatory advantage to the firm, is considered a fiscal subsidy that is illegal under EU competition policy. After investigating the cases, the EC concluded in all three cases that the APA did constitute illegal state aid and demanded that the tax benefit be repaid.

As of August 2018, the EC had three open investigations (see Table 1) of state aid involving APAs granted to IKEA by the Netherlands (EC, 2017b, December 18), McDonald's by Luxembourg (EC, 2015, December 3), and Gibraltar companies without an adequate evaluation to grant tax exemption (EC, 2017c, October 26). The EC has determined that state aid was provided and ordered recovery of the aid in six closed investigations involving APAs: Apple by Ireland (EC, 2016c), Starbucks by the Netherlands (EC, 2015b), Fiat Finance and Trade by Luxembourg (EC, 2015a), Amazon by Luxembourg (EC, 2017a), Engie (formerly GDF Suez) by Luxembourg (EC, 2018), and Belgian taxpayers under the Belgian "excess profit" tax ruling system (EC, 2016b).

The EC's treatment of APAs as state aid has been labelled "aggressive" and "uncharted waters for lawyers, tax planners and multinational corporations" (Bobby, 2017:191). Moreover, since several of the cases have involved MNEs headquartered in the United States, the United States government has paid close attention to the EC state aid cases. In a 2016 white paper, the United States Treasury argued that the EC's application of state aid law to APAs was new, departed from prior EU case law and EC decisions, was inconsistent with international norms, and was undermining the international tax system and the progress made under the BEPS (base erosion and profit shifting) project of the Organization for Economic Cooperation and Development (OECD) (U.S. Treasury, 2016).

We argue in this paper that the EU state aid cases are an example of the unintended consequences of a government policy developed to handle a problem in one realm that can spill over into another realm, particularly when the policy is misused or appears to have been misused in the first realm. The purpose of APAs is to reduce the likelihood of what in practice have been extraordinarily costly and protracted

**Table 1. EU Commission state aid cases by notification date, as of July 2018**

Member State	MNE/issue	Home country	Notification date to Member State	Date of decision	Case number
Belgium	Excess profit exemption in Belgium – Art. 185§2 b) CIR92	Various	07.11.2013	11.01.2016	SA.37667
Ireland	Apple	United States	21.02.2014	30.08.2016	SA.38373
Netherlands	Starbucks	United States	21.02.2014	21.10.2015	SA.38374
Luxembourg	Fiat	Italy	21.02.2014	21.10.2015	SA.38375
Luxembourg	Amazon	United States	20.06.2014	04.10.2017	SA.38944
Luxembourg	McDonald's	United States	03.12.2015	In progress	SA.38945
Luxembourg	ENGIE (GDF Suez)	France	19.09.2016	20.6.2018	SA.44888
United Kingdom	UK tax scheme for multinationals (Controlled Foreign Company rules)	Various	26.10.2017	In progress	SA.44896
Netherlands	Inter IKEA	Sweden	18.12.2017	In progress	SA.46470

Source: Assembled from information at [http://ec.europa.eu/competition/state\\_aid/tax\\_rulings/index\\_en.html](http://ec.europa.eu/competition/state_aid/tax_rulings/index_en.html).

disputes between MNEs and tax authorities. While APAs are used by taxpayers as tax planning tools, they are not designed to be instruments of tax minimization. Both taxpayers and tax authorities place a high value on the defined outcomes and tax certainty for the related party transactions covered in the agreement.

However, APAs are negotiated as one-on-one bargains between an MNE and a tax authority; as such, they can be misused to privilege one MNE relative to domestic firms and other MNEs. Moreover, even APAs that are wholly positive for both parties may give the appearance of misuse to outsiders because the agreements are negotiated in secret and little to no information is made publicly available. Thus, APAs may trigger “smell test” concerns by other governments, agencies and non-governmental organizations even when such concerns are unwarranted. For both reasons – abuse and perceived abuse – an APA can move over from the tax realm (where the APA is viewed as a beneficial policy that reduces MNE–state tax disputes) and into the – at least perceived – realm of competition policy (where the APA is viewed as a misused policy that inappropriately affects MNEs’ location decisions and competitive behaviors among rival firms).

The academic and professional literatures on state aid and income taxation are small but growing; see Bobby (2017); Cleary Gottlieb (2016); Evertsson (2017); Hrushko (2017); Liu (2018); Mason (2017a, 2017b, 2017c, 2017d, 2017e, 2018); Pellefigue and Finan (2018); Tavares, Bogenschneider and Pankiv (2016);

Shaviro (2016), and Sporken and Cattell (2015). Our paper contributes to this literature by analyzing the unintended spillovers of APAs and recommending policy changes to reduce these spillovers.

## 2. APAs in international taxation

### 2.1. The arm's length standard

For nearly 100 years now, source and residence rules formalized in bilateral tax treaties between countries have been used to determine jurisdiction and allocate the income tax base among countries (Byrnes and Cole, 2018; Eden, 1998, 2009). Since the mid-1960s, most countries have followed the OECD Model Income Tax Convention and adopted the separate accounting approach, treating MNE foreign subsidiaries as independent entities whose income is taxable in the host country up to the “water's edge”. Home countries choose to tax either on a territorial base (so foreign-source income is not taxed) or a worldwide basis (normally taxing foreign-source income only when repatriated and providing foreign-tax credits for host-country income and withholding taxes).

Transfer pricing is the setting of prices for transactions between or among firms that are commonly controlled or related parties; that is, the pricing of related-party transactions (also known as controlled or non-arm's length transactions) (Byrnes and Cole, 2018; Eden, 1998, 2016). Eden (1996, 1998, 2009, 2016) has argued that, from an institutional perspective, an international tax transfer pricing regime exists with its own principles, norms, rules and procedures. The regime is designed to lessen the transaction costs associated with MNEs' cross-border capital and trade flows, reduce opportunistic behaviors that could lead to over- or under-taxation of MNE income, and resolve disputes between MNEs and tax authorities.

The underlying principles of the regime (e.g., equity, efficiency, neutrality, and transparency) are supported by the regime's core norm: the arm's length standard (ALS). Under the separate accounting approach, transfer pricing rules are used to set prices and allocate the income from related-party transactions between tax jurisdictions. To prevent MNEs from engaging in transfer mispricing, governments have adopted the ALS as outlined in paragraph 1 of Article 9 in the various editions of the OECD Model Double Taxation Convention on Income and Capital (OECD, 1963, 1977, 2008, 2014):

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

In 1979, the OECD began to issue guidelines to tax authorities and MNEs on how to set transfer pricing rules to implement Article 9. The *Transfer Pricing Guidelines* (TPG) was first issued in 1995 and has been updated several times. The TPG is now used by more than 60 countries as the basis for their transfer pricing regulations, although there are significant differences across countries both in the specific rules and in their application (Byrnes and Cole, 2018; Eden, 2009, 2016). There are also significant differences within the EU; all but two Member States (Cyprus and Malta) have transfer pricing regulations, but their sophistication varies significantly (EC, 2016e, Appendix 8).

While the OECD has historically been the key international organization at the heart of the international tax transfer pricing regime, the United Nations (UN) has also played an important role in building the regime, particularly for tax authorities in developing countries. The UN Model Double Taxation Convention between Developed and Developing Countries also includes an article (Art. 9) on “associated enterprises” with the same arm’s length test. In 2013, the United Nations published its first set of transfer pricing guidelines for developing-country tax authorities; the second edition was issued in 2017 (United Nations, 2013, 2017). Thus, both the OECD and the UN Model Tax Conventions, which are the basis for nearly all bilateral tax treaties worldwide, endorse the ALS.

In both sets of guidelines, implementation of the ALS requires the completion of a comparability analysis that involves four steps. First, the associated enterprises in the MNE group are treated as if they were operating as separate entities and their related-party transactions are identified. Second, any conditions (including prices) for these related-party transactions that differ from the conditions that would have been obtained in uncontrolled transactions are identified and assessed in terms of their materiality. Third, whether or not the accounts of the associated enterprises need to be rewritten to ensure that the tax liabilities of the associated enterprises adhere to Model Tax Convention Article 9 is determined. Last, the profits and tax liabilities that the associated enterprises would have accrued had the conditions been obtained in uncontrolled transactions (in other words, had they been independent entities and accrued their true taxable income) are calculated.

There are five main transfer pricing methods: comparable uncontrolled price (CUP), resale price method, cost plus method, transactional net margin method, and profit split method (PSM). The first three methods are typically regarded as more direct applications of the ALS than the last two methods. The most appropriate method must be selected for each related-party transaction. When selecting the most appropriate method, these factors must be considered: the relative strengths and weaknesses of the various methods; the appropriateness of the method to the nature of the controlled transaction as determined by a functional analysis; the availability of reliable information (especially on the uncontrolled comparables) needed for the method; and the degree of comparability between the controlled and uncontrolled

transactions, including the reliability of any comparability adjustments that are needed to eliminate material differences between them. Last, because transfer pricing is not an exact science, there may be a range of equally reliable prices (the arm's length range) that can result from the application of a transfer pricing method.

## **2.2. Dispute settlement mechanisms**

The tax transfer pricing regime has procedures by which tax authorities can settle disputes and enforce compliance with MNEs. Domestic procedures are similar across OECD member countries; for example, there are procedures for auditing MNEs, handling tax appeals, and fighting disputes in tax court. Almost all of these procedures happen behind closed doors in negotiations between the MNE and one or more tax authorities. The negotiations can take place over 10 or more years, starting with the first audit of the MNE's financial statements and running through one or more tax court decisions if either party decides to appeal the court decision. Only at the tax court stage – after the judge has rendered a published decision – is any information typically made publicly available, and that information is heavily redacted. Thus, with the exception of court trials, none of the domestic tax procedures make their results available to the public.

## **2.3. Advance pricing agreements**

Partly owing to problems with *ex post* dispute settlement procedures, many MNEs have turned to APAs to reduce their tax risk (Eden, 1998: 469-76; Markham, 2012). The APA is designed as an *ex ante* dispute settlement mechanism negotiated before the related-party transactions take place although, in practice, APAs may cover related-party transactions in prior years as well as in future years. The APA allows the MNE and its tax authority to reach an agreement ahead of time on a mutually acceptable transfer pricing method, which is then applied to determine taxable income in that jurisdiction for some years in the future (DiSangro, Langdon, and Wongsrikasem, 2012).

The APA process typically works as follows. An MNE (the “taxpayer”) starts the APA process by requesting an APA from its tax authority (at the “pre-filing” stage). There may be several pre-filing meetings before the two parties decide whether to pursue an APA, and either party can withdraw from the process. If the tax authority decides to approve the application, the process moves into the “due diligence” stage. The taxpayer completes a detailed APA application. If the application is approved, the taxpayer and the APA team within the tax authority work together to develop a transfer pricing policy that is mutually agreeable. The tax authority reviews the materials submitted by the taxpayer, undertakes site visits, and can request additional materials or meetings. The APA team also completes its own functional

analysis and comparables searches, ending with a formal position paper that accepts or recommends modifications to the MNE's proposed transfer pricing policy.

The last stage is the documentation and signing of a binding contract between the MNE and the tax authority where the tax authority agrees not to seek a transfer pricing adjustment for a covered transaction as long as the taxpayer files its tax return for a covered year showing results (taxable income) consistent with the agreed-upon transfer pricing results. The actual agreement signed by the parties typically consists of three elements: (1) an agreement on the relevant facts and circumstances, (2) the transfer pricing method to be used, and (3) application of the method to determine an arm's length range of results. The APA covers identified transactions for a specified number of years, and the MNE's transfer prices over the life of the APA are expected to fall within the agreed-upon range of results.

The APA policy was first developed and introduced in the United States as IRS Revenue Procedure 91-22 in 1991, and since then has spread to more than 30 countries (EY, 2017). In 2012, only 390 APAs were in force within the EU; by 2015 the number of APAs had quadrupled to 1,252 and at the end of 2016 had nearly doubled again, to 2,053 (Ryding, 2018). The EU countries with the most extensive use of APAs in 2016, according to Ryding (2018), were Belgium (1095) and Luxembourg (599). The EU Joint Transfer Pricing Forum (2016) noted that Luxembourg had 599 APAs in place and in 2015 received 163 requests, granting 145. In the same year, the Netherlands received 261 requests and granted 236 APAs, having taken on average two years to complete each APA process. Belgium had received 522 APA requests and granted 602 APAs, having taken on average eight months, and had 1,105 APAs already in place as of 2015.

These numbers, however, represent only a very small percentage of MNE taxpayers. Estimates suggest that there are only 400 or so APAs in the United States, involving less than 4 percent of the more than 11,000 MNEs with U.S. parents and foreign affiliated entities (Stark, 2011). In addition, some MNEs will have multiple APAs addressing different product lines or entities, further reducing the percentage. Thus, APAs are rare, even in the United States, the country with the longest history and experience with this process. Part of the reason for the rarity of APAs are the large upfront costs involved for the MNE in terms of time, resources, and financial commitments (Markham, 2012). In addition, the MNE must "open the kimono" by providing large amounts of confidential information to the tax authority. Thus, the APA process has been requested primarily by large MNEs, often ones that are already in the tax appeal stage.

There are cases in which two tax authorities have negotiated a bilateral APA with an MNE that has operations in both jurisdictions. Bilateral or trilateral APAs are rare; for example, in 2016, there were 1,539 (EU) and 723 (non-EU) APAs in force in EU Member States (EU Joint Transfer Pricing Forum (2018)). Of these 2,262 APAs, there

were 89 (EU) and 123 (non-EU) bilateral or trilateral APAs. Since the EU agreements involve at least two EU governments, the actual number is smaller than the 212 APAs reported. The small number is clearly due to the time and effort involved in three-party bargaining over the facts and circumstances, the most appropriate transfer pricing method, and the arm's length range of taxable results for the MNE in both jurisdictions.

In sum, although APAs may suffer from a variety of flaws, national tax authorities use them as a policy to improve the business environment for foreign direct investment (FDI) by providing greater tax certainty for MNEs. In the tax realm, APAs are viewed as an effective *ex ante* dispute settlement mechanism that can offer significant benefits to both parties. While APAs are negotiated in secret and no information is made publicly available, this is also true for other tax dispute settlement procedures with the limited exception of tax court decisions.

We turn now to the second realm: state aid as a component of competition policy.

### **3. The EU state aid policy**

#### **3.1. Goal congruence in two-tier government systems**

In a two-tier system of government, state aid is defined as any form of aid granted by a lower-tier government or through the low-tier government's resources that, by favoring certain firms or types of activities, distorts or threatens to distort competition among firms within the upper-tier government's jurisdiction. A major concern behind a state aid policy is that firms receiving aid from a government can be induced to locate in specific sub-jurisdictions (e.g., inward FDI) or can use the funds to engage in aggressive competitive behaviors against rival firms. A state policy is designed to prevent lower-tier governments from engaging in location subsidy races, favoring "local champions", or otherwise distorting competition among firms within national borders.

State aid cases, given their construction (i.e., an upper-tier government regulating the policies of its lower-tier governments), are found typically in institutions such as preferential trading agreements (e.g., NAFTA, Mercosur, the EU) or two-tier federal systems with national and state, provincial, or local governments. In such institutions, to achieve the goals of the upper-tier government or agency throughout its jurisdiction, the upper-tier authority must ensure goal congruence across the lower-tier governments, typically by using a system of penalties and/or rewards. Two-tier federal systems of government and customs unions normally include a state aid policy to ensure a level playing field for all firms, regardless of their geographic location in the jurisdiction of the upper-tier government.



### 3.2. TFEU article 7(1)

A state aid policy has been a major pillar of EU competition policy dating back to the EEC Treaty of 1957, which prohibited any aid that distorted or threatened to distort competition insofar as it affected trade between Member States. State aid is an upper-tier (EU) policy, not a lower-tier (Member State) policy, which is designed to prevent Member States from offering aid to firms and activities (“undertakings”) that could negatively affect the EU internal market. The EU’s official policy on state aid appears as Article 107 in the Treaty on the Functioning of the EU (TFEU), in which the first paragraph states that (EU, 2008):

Save as otherwise provided in this Treaty, 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 common market.

TFEU Article 107(1) provides for a general prohibition of any aid granted by an EU Member State where the aid meets all four of the following conditions:

1. Funded directly or indirectly by a Member State or through its resources;
2. Favors specific undertakings or the production of certain goods (i.e., provided on a selective basis or has a selective character, as opposed to general measures that apply equally to all market participants in comparable circumstances);
3. Confers an advantage that could not (or not on the same terms) have been obtained from private market participants; and
4. Distorts or threatens to distort competition and affects trade between Member States.

Article 107(1) encompasses any form of government aid including direct grants or subsidies by the state to a firm; loans or guarantees by the state to a firm at below-market interest rates (e.g., capital injections or recovery of debt); purchase by the state of goods or services at above-market prices; sale of state assets at below market value (e.g., privatization) or state purchase of private assets at above market value; and reduction in the tax rate or tax preferences provided by the state to a firm.

### 3.3. Exceptions to TFEU article 107(1)

There are five exceptions to Article 107(1), and some have been important in the recent state aid cases. The exceptions, which appear in TFEU Articles 107(2,3), are as follows:

- **Aid that meets the private market test:** If a Member State intervenes on terms that would be acceptable to a private sector operator, the measure does not confer an advantage and is not state aid.

- **De Minimus Rule:** Financial aid provided by a Member State to a private sector operator that is below €200,000 over three years is deemed to be too small to be state aid.
- **Compatible Aid:** Aid by a Member State that is of a social character, is provided to repair damage from natural disasters or in exceptional circumstances or is in the form of competition for the amalgamation of East Germany and West Germany, is not state aid. [TFEU Article 107(2)]
- **Aid that Meets the Balancing Test:** Aid that is designed to promote the development of less developed regions or certain activities (e.g. culture, heritage conservations) where the aid contributes to common interest is not state aid. [TFEU Article 107(3)]
- **Aid that Is Not Selective:** If no advantage is conferred on a selective basis – either there is no advantage, or the advantage applies to all firms – it is not state aid.

### 3.4. Selectivity and advantage

When a government provides a firm with a direct subsidy, it is relatively easy to determine whether or not the subsidy qualifies as state aid. The determination is based on two factors: (i) whether an advantage has been granted (i.e., does the subsidy have the potential to distort competition within the country's borders) and (ii) whether the advantage is selective (i.e., is the advantage restricted to one or more particular firms or activities). The advantage needs to be both selective and liable to distort the level playing field in an internal market between certain undertakings and their competitors in order to be classified as state aid.

This perspective follows from the wording of TFEU Article 107: “The measure must be specific or selective in that it favors certain undertakings or the production of certain goods”. Mason (2017a: 646) defines selectivity with respect to state aid cases as, “A measure is selective if it is not available on the same terms to every similarly situated undertaking”. Thus, selectivity involves discrimination.

The requirements of “advantage” and “selectivity” are also intertwined. The EC’s opinion is that no advantage can be deemed to exist if all firms that find themselves in a legally and factually comparable situation have access to and can benefit from the same treatment. Measures that are *de facto* available to all firms in the same legal and factual circumstances in a Member State are considered general measures and for that reason do not constitute state aid. As long as the state “held the enterprise at arm’s length” the state has not taken an action “that independent operators would not have taken” and thus the policy is not considered to be selective (Mason, 2018: 772).

For the purpose of assessing selectivity, the European Court of Justice (ECJ) has drawn a distinction between general schemes and individual aid measures, arguing that “the selectivity requirement differs depending on whether the measure in question is envisaged as a general scheme of aid or as individual aid”. For an individual aid scheme, “the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective”. (ECJ, 2015a: 60). The assessment of the selectivity criterion follows the outcome of the assessment regarding the existence of an advantage.

Note that whether the state’s goal or intention was to grant an advantage to an undertaking is irrelevant; what matters is whether the advantage has the potential to negatively affect competition within the country. For example, in *France Telecom v. European Commission*, the ECJ notes that “the nature of the objectives pursued by State measures and their grounds for justification have no bearing whatsoever on whether such measures are to be classified as State aid”; what matters is not causes or objectives but rather effects (ECJ, 2011, paragraph 17).

In addition, there is no requirement to demonstrate that competition has been negatively affected in practice; all that is required is to demonstrate that the potential exists for this to happen. Thus, the criterion of selectivity, in practice, has turned out to be more important than the criterion of conferring an advantage. As noted by the ECJ, “In matters of tax law...the decisive criterion is whether a provision is selective, because the other conditions laid down in Article 107(1) are almost always satisfied” (ECJ, 2015b, paragraph 114). The EC does not have to prove that the aid is actually distorting competition or having any real impact on trade flows, all that is needed is the possibility that it might in future have such an impact. Neither does the firm or activity have to be involved in cross-border trade; all that is needed is the possibility that in future it might be so. Thus, selectivity has become the key criterion in EU state aid cases.

### **3.5. The state aid policy process**

The EC’s Directorate General for Competition has the responsibility to enforce the EU state aid policy. The EC has broad investigation and enforcement discretion (Mason, 2017a).

In terms of the policy process, Member States are required to report any new aid measure to the EC and must wait, with a few exceptions, for the results of a preliminary investigation by the Commission before instituting the policy (EC, 2013). Any aid that is granted without prior authorization from the EC is automatically considered by the EC to be unlawful state aid. A preliminary finding by the EC that aid has been misused triggers a formal investigation procedure under Article 108(2) of the TFEU. Formal investigations can also be triggered by third-party complaints

or by the EC's own investigations. The investigation process has no formal time limits so could go on for several years.

The EC can make a positive (no aid or compatible aid), negative (aid) or conditional (qualifies as aid/not aid if...) decision. If the decision is negative, the Member State must recover the aid from the firm that received the aid, with interest, for aid that has already been given. All decisions and procedures of the EC are subject to review by the EU General Court and can also be appealed by the Member State to the ECJ. If the Member State does not comply with the decision, the EC may refer the case to the ECJ also.

#### **4. The unintended consequences of APAs: APAs as state aid**

Having explored the role of APAs as an *ex ante* dispute settlement mechanism in the international taxation realm, and the role of state aid in the EU's competition policy realm, we now bring the two together to analyze the unintended consequences of APAs. How and why did APAs move from a positively viewed component of international tax policy to a negatively viewed (or at least viewed with suspicion) component of competition policy?

##### **4.1. Are income taxes a presumptive form of state aid?**

Although Article 107(1) was written with subsidies in mind, for many years the policy has been understood to also include income taxes as a possible form of state aid. Since the early 1960s the ECJ has defined state aid as including any charges that are similar in character and effect to a subsidy (see cases cited in footnote 3, Federal Ministry of Finance, 2017: 9). Thus, both financial (e.g., subsidies) and fiscal (e.g., tax benefits) measures can be characterized as state aid. Tax benefits can provide an advantage because "the loss of tax revenue is equivalent to consumption of State resources in the form of fiscal expenditure". (EC, 1998: paragraph 10).

The EC has argued that any tax measure that reduces a firm's tax burden can potentially be a form of state aid, including a reduction in the tax base (e.g., special deductions), total or partial reduction in tax (e.g., tax credits or exemptions) or deferment, and cancelation or rescheduling of tax debt. In order for tax measures to not potentially qualify as state aid, "they must be effectively open to all firms on an equal access basis, and they may not be *de facto* reduced in scope through, for example, the discretionary power of the State to grant them or through other factors that restrict their practical effect" (EC, 1998: paragraph 13).

Within the EU, Member States have sovereignty (jurisdiction) over direct taxation (e.g., income taxes), but their sovereignty is conditional on two factors: (i) positive integration (abiding by EC Directives) and (ii) respect for the TFEU (non-discrimination

and list of freedoms). Therefore, any form of state income tax or tax preference that (i) can distort or threaten to distort competition and affect trade within the EU and (ii) is of a selective character, is in violation of TFEU Article 107(1). As a result, corporate income tax policies of EU Member States (lower-tier EU governments) can fall within the EC's jurisdiction and thus within the purview of the EU upper-tier government.

As outlined earlier, whether or not a government policy qualifies as state aid under TFEU Article 107(1) requires consideration of two factors: (i) whether an advantage has been granted (i.e., whether the subsidy has the potential to distort competition within the country's borders) and (ii) whether the advantage is selective (i.e., whether the advantage is restricted to one or more particular firms or activities). In practice, selectivity, not advantage, has become the key factor in state aid cases.

As Mason (2017a, 2018) points out, selectivity is much more difficult to determine in tax cases because only governments levy taxes; there is no organization equivalent to the state that acts an "independent market operator". The market baseline for comparison – what an independent firm or organization would have done under the same facts and circumstances – is not available.

The EC's response to income tax cases has been therefore to use the benchmark of the Member State's ordinary income tax rules, following a three-step analysis to determine whether a particular tax measure is selective (EC, 2016a). First, the common or normal tax regime applicable in the Member State is identified (the so-called "reference system"). This involves consideration of items such as the tax base, the tax rates, and so on. Second, the EC must determine whether the tax measure in question constitutes a derogation from the reference system; that is, whether the tax benefit differentiates between firms that are, relative to the tax system's objectives, in a comparable factual and legal situation. If the measure does constitute a derogation from the reference tax system, the third step is for the EC to determine whether the measure can qualify as an exemption under Article (107(2,3); for example, if the policy is based on the basic or guiding principles of the tax system and so not considered to be selective.

For income taxes, determining the answers to these questions is not as easy, and appearances can be deceiving. Consider, for example, a six-month holiday that is open to all firms as long as they meet a specific set of criteria. Waiving enforcement of a legally assessed tax by offering a tax holiday should not distort competition within the country's borders as long as the tax benefit applies to all firms. However, the tax holiday may be deemed to be selective if the requirements can be met by only a small subset of firms; for example, when there are multiple criteria or one of them is so restrictive it can be met by only a few firms. In this situation, the tax benefit is *de jure* (on paper) universal but *de facto* (in practice) selective and is therefore classified as state aid.

Moreover, the ECJ stated in *France Telecom v. European Commission* (Case C-81/10 P, *France Telecom*, ECU: EU: CD: 8 December 2011: 811, paragraphs 16-18) that identifying an advantage depends on what the normal tax regime is applicable to comparable undertakings (firms or activities). If a derogation from the normal tax regime creates a tax saving when compared with the tax owed under the normal tax regime, the tax differential can be considered as a selective benefit to that undertaking. If that selective benefit also constitutes an advantage, the two components together imply that the derogation qualifies as state aid, which the ECJ found in the 2011 *France Telecom* case (ECJ, 2011). In a contrary decision (*Autogrill España v. European Commission*; ECJ, 2014), the ECJ found that even if a tax policy was a derogation from the normal tax regime, the tax differential would not necessarily be a selective benefit, and thus found against the EC.

The lesson from the *France Telecom* and *Autogrill España* cases is that declaring that a tax policy is state aid involves determining (i) the income tax that would be paid under the normal tax regime, (ii) the tax difference due to the derogation from the regime, and (iii) whether the difference is both selective and confer an advantage to an undertaking. This first requires a determination of what is a “normal” tax regime for an undertaking in a country at a point in time, which is inherently difficult given the complexity of modern tax codes. Moreover, there are large differences in tax systems across countries and within countries (e.g., differences in tax rates and bases by activity, size, and type of firm).

Mason (2018) argues that the determination of the reference tax base has been the most problematic and controversial aspect of the EC’s APA cases. Changing the baseline reference system automatically changes the calculation and size of the tax differential, which is a key component in determining selectivity. In any Member State, there can be several possible benchmarks depending on whether only domestic income is included or whether foreign source income is included or exempted. Adding in the differences across EU Member States in their taxation of domestic- and foreign-source income in terms of bases, rates, credits, and deductions, it is not surprising that there have been legal appeals challenging the EC’s benchmark calculations. Moreover, as any state aid that has been prohibited under EU law must be paid back retroactively for ten years with interest, a considerable amount of financial risk can be created for EU taxpayers.

In sum, the answer is yes, income taxes can be a presumptive form of state aid because they can both be selective and confer an advantage. The problem is one of determining the amount of selectivity and advantage, which is difficult because the benchmark standard typically used in subsidy cases – the market test – is harder to implement when a tax benefit is the offending policy. Additional complications are created when the taxpayer is an MNE, which we address in the next section.

## 4.2. Are APAs a presumptive form of state aid?

The EC has sent EU tax authorities mixed signals about the desirability of APAs as a tax dispute settlement mechanism. On the one hand, the EC has encouraged Member States to use APAs and advance rulings as *ex ante* tax procedures to reduce the likelihood of MNE–state transfer pricing disputes. For example, EC (2001: 355) argues that “Member States clearly should be encouraged to provide the possibility for businesses to obtain under reasonable conditions an APA in important transfer pricing cases” because APAs effectively address the inherent uncertainty relating to the application of transfer pricing rules and methodologies. EC (2007) discusses in detail the advantages and disadvantages of APAs and how an APA program should best be established by EU Member States. Nowhere in the document is state aid mentioned as a possible problem. EC (2016a: 169) also states that APAs are an efficient tool for dispute settlement, with valuable advantages for tax administrations and taxpayers.

On the other hand, the EC has noted that APAs are almost presumptively state aid because they are opaque and flexible. Moreover, any tax benefit that is specific to an individual firm or activity can potentially be state aid if viewed by the EC as conferring an advantage. EC (1998: 22) notes specifically that, “Every decision of the administration that departs from the general tax rules to the benefit of individual undertakings in principle leads to a presumption of State aid...”. If administrative rulings “merely contain an interpretation of general rules”, they do not generate a presumption of state aid; however, given the “opacity of the decisions taken by the authorities and the room for manoeuvre which they sometimes enjoy”, a presumption of state aid is well founded.

To qualify as illegal state aid, a policy must both be selective and provide an advantage that has the potential to distort competition and trade. APAs are clearly selective policies. Whereas all MNEs have the right to apply for an APA, in practice, the number of MNEs that both seek and receive an APA is very small. Moreover, APAs are negotiated behind closed doors and not made public, so there is more room for the MNE and State to engage in bargaining that leads to “special arrangements”. Even if the APA is a straightforward application of an existing transfer pricing methodology, the perception by outsiders is likely to be that the APA is a bilateral secret bargain that does not pass the “smell test”.

The EC has extracted several indicia for selectivity from its analysis of the six state aid investigations concluded to date. A first indicator is the duration of the APA. An open-ended (indefinite) duration of the APA triggers doubts as to the appropriateness of the agreed transfer pricing arrangement for later years because market conditions may change over time. According to the EC, the method accepted by the tax authorities should consider changes, if any, in the economic environment and/or in the remuneration levels required, which may occur in the

years following the ruling application. In the EC's view, an agreement between a tax authority and a taxpayer that has no end date makes less accurate any predictions as to future conditions on which that agreement is based, thereby casting doubt on the reliability of the method endorsed by that APA (EC, 2016c: 364).

The EC's assessment of selectivity and advantage in an APA also depends on the transfer pricing methodology and arm's length results that are the "heart" of the APA (EC, 2016d: 12). In state aid cases involving APAs, the EC refers to the TPG when determining whether transfer prices for tax purposes conform with the ALS (EC, 2017a: 64). If the EC concludes that the transfer pricing method in the APA deviates from the TPG specifically for the purpose of lowering the tax base of the applicant, the EC can use this conclusion as evidence of selectivity and advantage. In particular, the EC has raised doubts regarding the appropriateness of the Member State's choice of a transfer pricing method or pointed out the existence of alleged inconsistencies in the practical application of the method (Byrnes, 2016a, b).

EC (2017a: 64) states that whenever the application of the transfer pricing methodology in an APA follows the TPG, the APA itself does not amount to state aid under TFEU Article 107(1). However, the EC has also stated that the use of the most appropriate transfer pricing method does not rule out *per se* the existence of a state aid. The choice of method and the parameters that support its application must still be tested against the "market-based outcome" standard. EC (2016d) pointed out that the approximate nature of the ALS cannot be used to justify a transfer pricing analysis that is either methodologically inconsistent or based on an inadequate comparables selection. The EC has acknowledged that there are cases in which 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" (EC, 2016a: 171).

EC (2016e) has also made the point that rulings based on a two-sided approach (e.g., CUP and PSM) are less likely to deviate from a market outcome. The EC approves of PSM because all sides of the transaction are allocated a share of the overall profit in a consistent manner and all jurisdictions involved divide the full amount of profits between the related parties. In support of this position, the EC (2016a, paragraph 173) cited the 2006 ECJ case *Belgium and Forum 187 v. Commission* (ECJ, 2006). The EC's preference for two-sided transfer pricing methods, in particular for the profit split method, rather than the transactional net margin method (or its United States cousin, the comparable profits method) has been of particular concern to the United States Treasury because the method is regularly used in the United States (U.S. Treasury, 2016).



In sum, are APAs a presumptive form of state aid? The purpose of an APA is to clarify an MNE's tax payments in the future, providing the firm with greater certainty and less likelihood of a tax dispute. As such, an APA does provide an MNE with a lower tax risk relative to MNEs that do not have an APA. Whether this advantage distorts competition and affects trade patterns is not clear, but the EU state aid policy requires only that the tax benefit could affect competition and trade, a much lower hurdle. In sum, APAs have the potential both to be selective and to provide an advantage. Thus, they are "fair game" for EC investigations, and in hindsight, it should not have been surprising to MNEs and EU tax authorities that APAs had the potential for unintended consequences in the competition policy arena. The two implicit "smell tests" identified in EC (1998) – opacity of the ruling and the state's room for manoeuvre (flexibility) – both raise the likelihood of an investigation.

## **5. Policy recommendations to reduce the unintended consequences of APAs**

We have argued earlier that the EC's investigations into the use of APAs by Member States as a form of state aid should have been expected. Although the EC's activities may have been "aggressive" and the linkages between APAs and state aid "uncharted waters", it is nonetheless the case that government policies can and do have unintended consequences. Policies developed for one arena tend to have spillover effects in other arenas that generate second-round policy responses. In this section, we make some policy recommendations designed to reduce the unintended consequences of APAs. We look first at the APA process in the international taxation realm and then at the APA process in the state aid realm.

### **5.1. APA policy recommendations**

APAs were developed as an *ex ante* dispute settlement mechanism and have been very successful in this role. However, the nature of the process – "under the table", one-on-one bargains between an MNE and a tax authority – by their very nature lend themselves to bargaining models and opportunistic behaviors. In a world where governments are interested in creating domestic employment and attracting inward FDI, particularly in strategic or high-value industries, fiscal incentives such as tax rebates are an easy policy tool. Their lack of visibility also makes them attractive to both MNEs and governments. Thus, selectivity and advantage are two of the benefits that MNEs seek when negotiating an APA, and tax authorities are aware that the APA process can have that effect for firms. What, then, can be done if tax authorities want to continue using APAs as a dispute settlement mechanism but want to lessen the risk that the policy will be ruled to be illegal state aid?

Our first recommendation is perhaps the most radical but at the same time the most obvious: more "light" is needed in the "dark corners". At present, only a few

countries publish summary statistics on their APAs. We recommend that stylized information on individual APAs, with the names of the parties involved removed, be made publicly available in the same way that the 24-hour global trading APAs in the United States were made public in the 1990s (Eden, 1998, 2016). Tax authorities should publish “best practice” templates based on actual APA settlements, which can be suitably disguised to protect the given firm’s key information. Tax authorities should also publish stylized case studies as best-practice templates that are made available on the tax authority website where they could be analyzed and adopted by other tax authorities and MNEs. Although it is important at the same time to protect commercial secrets, greater transparency should improve the overall process and make APAs less likely to fall afoul of state aid regulations. We recognize that the cost may be that fewer MNEs are willing to apply for an APA, fearing the loss of confidentiality for key information such as trade secrets. More public information about APAs, however, should also deter their misuse.

Our second recommendation is that bilateral APAs where two or more tax authorities develop and agree to a transfer pricing arrangement involving one MNE should be encouraged where possible. Bilateral APAs mean more governments are at the table and involved in the bargaining process. The Commission itself has made this point, arguing in EC (2016d) that a bilateral APA is preferable to a unilateral APA, and that having two governments at the table should trigger less room for state aid.

While bilateral APAs do offer benefits, it is important to note that not all tax authorities have the same experience, training and resources to process and negotiate an APA. Moreover, negotiating a bilateral APA adds significantly to the resources needed and time involved relative to a unilateral APA. Collusion between two parties against the third party (e.g., the two tax authorities against the MNE) may also create problematic bargains. Still, where both tax authorities have experience with APAs the bilateral approach should reduce the risk of a state aid case. This includes situations where one of the tax authorities is in a developing country; several developing countries (e.g., China and India) now have experience with bilateral APAs.

Our third recommendation is that tax authorities need to develop clear internal documentation of their APA negotiations, methodologies, and outcomes. The TPG (OECD, 2017) provides detailed instructions on best practices for APAs; these best practices should be adopted and followed by EU Member States. This also involves the administrative level in terms of training tax auditors, economists, and lawyers in the tax authority on how to develop, implement and monitor APAs. Capacity building in the tax authority and better documentation should reduce the likelihood of the EC finding errors in an EU Member State’s APA process.

Our fourth recommendation is that tax authorities should improve and make better use of the two other main types of international dispute settlement procedures,

the mutual agreement procedure (MAP) and the binding arbitration process, and the way they interact with the APA process (Byrnes and Cole, 2018; Eden, 1998; Markham, 2012, 2017). The MAP and binding arbitration are *ex post* dispute settlement mechanisms available only to countries that have signed a bilateral tax treaty. The need for APAs would be reduced if alternative dispute settlement mechanisms were more effective; in addition, negative spillovers from APAs to the MAP and binding arbitration processes should be reduced. It is important to note also that both the MAP and binding arbitration processes are also conducted in secret with little public information.

Under the MAP, designated representatives (“competent authorities”) come together to settle a tax dispute involving an MNE located in both jurisdictions. Markham (2017) argues that the MAP process has been problematic in practice. Because the MAP only requires the two tax authorities to “endeavor” to reach a settlement, approximately one in 10 MAP cases do not settle (and so the MNE is double taxed) and the cases that do settle take on average nearly two years. In addition, the backlog of unresolved MAP cases is large and growing.

Within the EU, EU law supersedes the domestic laws of EU Member States; as a result, EU law typically trumps bilateral tax treaties negotiated between a Member State and another country (Long and Erwin, 2016). A fourth actor – the EC – in addition to the three main actors (the two tax authorities and the MNE) is thus inserted into the MAP. This creates two problems. First, bargains hammered out between tax authorities through the MAP can be overturned by an EC ruling that the transfer pricing policy constituted state aid and must be recovered by the Member State (U.S. Treasury, 2016). Second, if a foreign MNE pays the assessed back taxes plus interest to the EU Member State, the collection process raises the issue of whether the taxes can generate foreign tax credits in the home-country jurisdiction. Moreover, in some home countries (e.g., the United States) all legal remedies including appeals must have been exhausted before foreign tax credits can be paid, so that the process can take years (Long and Erwin, 2016).

Binding arbitration is a relatively new dispute settlement mechanism (Eden, 1998; Markham, 2017). Strong arguments for a binding arbitration process to handle transfer pricing disputes have been made for many years (Shoup, 1985). In 1990, the EU Arbitration Convention was adopted and ratified by the 12 Member States in 1994 (Eden, 1998: 632). Binding arbitration was also included in the 1995 Canada–United States bilateral tax treaty protocol (Eden, 1996: 82). However, it was not until 2008 that the OECD added binding arbitration to the OECD Model Tax Convention and 2011 before binding arbitration was added to the UN Model Tax Convention. Markham (2017: 169) provides a useful overview of the international diffusion of the binding arbitration procedure, concluding that “few countries have embraced mandatory binding arbitration”, which she views as “a disappointing outcome”.

The situation for the MAP and binding arbitration may be improving. In November 2016, more than 100 countries concluded negotiations on a multilateral convention to prevent BEPS. Part VI of the Convention (OECD, 2016) contains detailed regulations on mandatory binding arbitration in Articles 18-26. As of 23 July 2018, the Convention has been signed by 83 countries and nine countries have ratified it (OECD, 2018b). The EU has also adopted new legislation designed to improve both the MAP and the Arbitration Convention procedures for tax disputes among EU Member States (EU, 2017). A last example of the improving situation for dispute settlement procedures is the new OECD International Compliance Assurance Programme (ICAP) pilot, launched in January 2018 by eight tax authorities, which is designed to share information among tax authorities (OECD, 2018a).

## 5.2. State aid policy recommendations

As all APAs involve related party transactions and the selection of a transfer pricing methodology to determine taxable income and taxes paid to a tax authority, determining selectivity and advantage in state aid cases where APAs are involved is clearly a highly complex endeavor. The EC's interpretation of the ALS in state aid cases involving APAs has been viewed as confusing and lacking clarity (Mason, 2018). Reading the EC and ECJ decisions on state aid involving APAs (e.g., Starbucks, Apple, and Amazon) confirms this opinion.

In our view, the appropriate methodology for the comparison is as follows. First, the related party transaction must be tested against what independent enterprises would have done under the same facts and circumstances had the independent enterprises received the same tax benefit. This test must be done in terms of pre-tax operating income, not after-tax income, as required in transfer pricing comparability analyses. Second, the result must then be compared with the counterfactual of no tax benefit (the reference tax system) for independent enterprises.

In other words, the process involves two steps or stages (see Figure 1). One stage is based on the ALS, which compares the results of the related party transaction with the results of transactions undertaken (or that would have been undertaken) by independent entities operating under the same facts and circumstances as the related parties. In this step we determine whether the two related parties are at arm's length from one another by conducting a comparability analysis between the controlled transaction and the reference transaction in terms of their pre-tax operating incomes. If a material difference is identified, we make an adjustment that in effect puts the controlled transaction "in the shoes" of the reference transaction.

The second stage is the selectivity test in state aid cases that compares the results of the hypothetical transaction by an independent entity (the results of the first stage) with the tax benefit and the results of transactions undertaken (or that would

have been undertaken) by independent entities operating under the reference tax system without the tax benefit. In this step we determine whether the tax authority is at arm's length from the MNE by conducting a comparability analysis between the tax benefit system and the reference tax system. The second step follows the EC's normal practice of determining selectivity and advantage when comparing two unrelated parties, where one has received a tax benefit and the other has not.

Completion of both arm's length tests – valuing the transaction between the two related entities in the MNE (stage 1) and valuing the tax benefit between the state and the taxpayer (stage 2) ensures that both the ALS and the selectivity test have been appropriately applied.

Implicit in the above is a hidden question: whether the comparability analysis for ensuring the ALS is met with respect to transfer pricing (stage 1) should be done with the Member State's own transfer pricing regulations or with the EC's interpretation, and, if the latter, whether the EC should use the government's transfer pricing rules or the TPG.

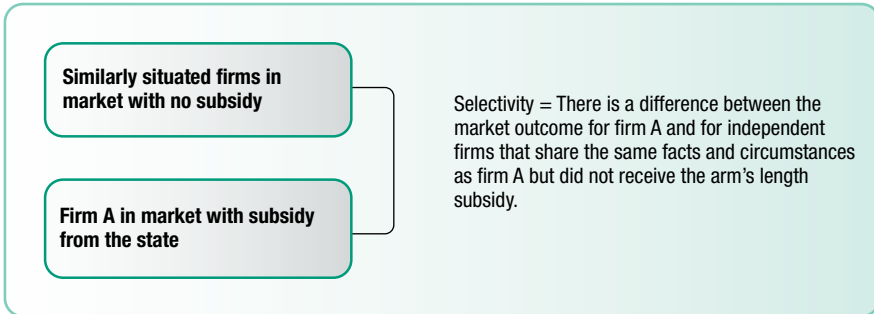
There are some reasons to argue for the upper-tier government being the final authority and for using the TPG rather than the Member State's regulations. First, not all EU Member States have formal transfer pricing regulations and their quality (both in terms of regulation and enforcement) varies significantly, particularly in the context of related party transactions that are difficult to value, for example, those involving intangible assets as documented in EC (2016e). Moreover, the less detailed and more opaque the country's transfer pricing regulations are, the greater the likelihood that the regulations can be misused or misinterpreted by the tax authority. Third, the incentives to use transfer mispricing through APAs is likely greatest for those governments attempting to attract inward FDI, which is exactly the motivation behind the EU state aid policy. The TPG also is generally accepted by almost all tax authorities worldwide, not only in EU Member States.

Yet, there are also good reasons to argue that the authority should rest with the lower-tier governments, not the EC, and that Member States should be able to use their own transfer pricing regulations, not the TPG. The principles of subsidiarity and sovereignty are strong arguments for the lower-tier government's transfer pricing regulations being the determining factor on the grounds that "EU Member States have a sovereign right to determine their own fiscal policies and tax regulations" (Hrushko, 2017: 328). Also, transfer pricing regulations have the force of law within a country, whereas the TPG does not.

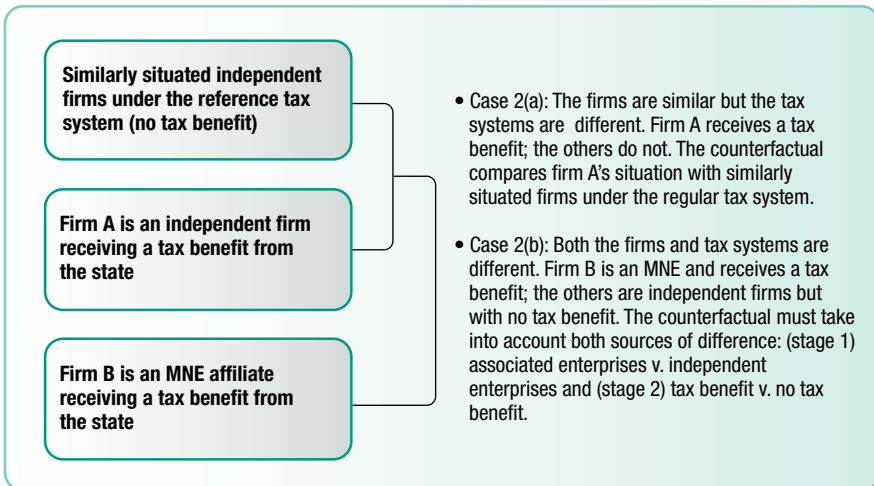
In addition, some EU tax authorities (e.g., Germany, the Netherlands, the United Kingdom) have developed detailed transfer pricing regulations and have much more experience applying the rules than do EC staff members. The EC is not a tax agency and has little experience in the arcane world of transfer pricing regulation. Many EU tax authorities have also been long-time members of the OECD committees in which

## Figure 1. Counterfactuals in determining selectivity in state aid cases

### Case 1: The firm receives a subsidy from the state



### Case 2: The firm receives a tax benefit from the state



the TPG rules are developed and revised. Thus, replacing the assessments of tax authorities with those of less experienced regulators may generate substantial and unnecessary errors. Moreover, using EC staff interpretations of the TPG creates substantial tax risk for MNEs. The process may also discourage inward FDI, with potential negative effects on local competition if the number of foreign entrants declines as having fewer firms encourages more oligopolistic firm behaviors.

Whichever level of government is accorded primacy, the EC's attempt to apply transfer pricing rules to related party transactions within an APA is akin to opening

Pandora's box. In our opinion, the most sensible answer is for the EC to accept the transfer pricing methodology and results developed by the tax authority in the APA (stage 1) – unless there are clear and manifest errors in the APA process – and focus solely on stage 2: whether the state is at arm's length from the taxpayer. We therefore recommend that the EC's assessment of APA cases in terms of application of the ALS be restricted to procedural violations (e.g., cases where a state does not have specific, detailed transfer pricing regulations or has no to little administrative experience with transfer pricing regulation) that have a material effect, rather than start down the path of substantively redoing the APA – that way "be dragons!" and best avoided.

## 6. Conclusion

An APA is a formal arrangement between a tax authority and a taxpayer involved in cross-border related party transactions where the goal is to determine an appropriate transfer pricing methodology for related party transactions according to the country's transfer pricing regulations. A key characteristic of an APA is that it is a discretionary, confidential tax ruling negotiated between the MNE and a tax authority. The MNE approaches the tax authority and requests an agreement to cover a certain activity or all activities within an MNE legal entity or entities. The agreement determines the arm's length return on the activity or activities for a specified number of years (typically, four or five) and may be renewed if there is no change in the MNE's material conditions and both parties agree. The benefits of an APA for the MNE include greater tax certainty, reduced transfer pricing risk, and protection against tax penalties. APAs can also help both parties resolve complex and non-routine transfer pricing issues.

However, some of the core advantages of an APA can turn out to be unintended disadvantages in a regional context such as a customs union, where competition policy is used by the upper-tier government to enforce a level playing field. In the context of competition policy, APAs can be viewed as hidden, discretionary policies used by lower-tier governments to attract or retain inward FDI by offering individual MNEs preferential tax treatment. In this situation, the APA as a dispute settlement mechanism changes and becomes a form of illegal state aid.

Our assessment is that certain changes could be made to the APA and state aid policy processes that should lessen, but probably not eliminate, the unintended consequences of APAs. We recommend that information on individual APAs be more publicly available and that tax authorities shift from unilateral to bilateral APAs when at least two tax authorities are involved. We also recommend that tax authorities' capacity to document and administer APAs be improved. Lastly, we recommend that the EC restrict its investigations in APA cases to what we have called stage 2 issues (assessment of tax benefit). The EC should accept the APA

transfer pricing methodology (stage 1), except in situations where the transfer pricing rules and procedures at the national level either did not exist or were not followed and material violations likely occurred.

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