Difficulties of the application of the State aid’s selectivity criterion

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I. számú melléklet

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1. Introduction

During our history, cross-border trade was always significant for economies. Most of the countries demanded such goods, which could not be found in their territory or from which they had not enough in their territory for their demand. Due to the development of technology in areas such as communication, infrastructure, finance and production processes, trade became easier, faster and more important. However territorial differences remained remarkable, trade structure changed a lot during the centuries. Trade of goods which could be produced cheaper in other countries gained more ground because of the cheaper transportation possibilities, and the improvement of communication technology made easier the trade of services between states. Furthermore, the production of some of the goods and services we use today is so complex, expensive and needs such knowledge, that an immense amount must be produced to be lucrative enough and so they has to be distributed in several countries.

Moreover, change in economic thinking helped that process too. During the early years, sounds of protecting the inner market were big enough to give rise to economic policies like mercantilism. People thought, that the outflow of money and goods from the country is bad for the economy, thus they wanted to keep and accumulate them through highly regulated cross-border trade. Such ideas were followed by mercantilism, which was a significant economic theory in Europe from the 16th to the 18th century. Not only the economy was badly effected by such ideas, but they could lead to political stress and pressure between countries. As the economists were able to gain more information on economic processes, the earlier method of thinking was revaluated and despite of some political sounds questioning the importance of opened economies, the leading view is today that barriers should be abolished and the flow of money, workforce, goods and services should be facilitated in cross-border trade.

The above mentioned change in economy led to increasing number of multinational enterprises (MNEs). Besides their sales activity in many countries, economic openness helped MNEs to organize their whole group in a way which ensures them the most effective operation regarding costs. Building factories in countries having cheap workforce led to goods easier to achieve for people, resulting bigger consume and higher profit for corporations. But not only this physical way of cost cutting was followed by MNE’s, but another – sometimes really significant – cost element gained in importance
when planning group structure and transactions between affiliated group members: that is tax.

Different tax rates and tax calculation methods in the countries give rise to a huge number of tax planning possibilities for MNEs. As firms try to keep their costs low, they count with the expected tax liability in the different states and shift their income into low tax jurisdictions. The way this profit shifting is made can be various and not always legal. Since artificial income allocation means a loss in tax income for high tax countries and an unfair advantage for big firms at the expense of little ones, states try to create their tax laws in a way to make profit shifting out from the country more difficult. Furthermore, some states try to compete with another states through generous tax laws and attract money into the country. That latter is dangerous, as it can lead to harmful tax practices, which means that some of the states apply morally questionable measures in this respect.

Recognizing this problem, many steps were taken by states, the EU, and organizations such as the OECD to create the world of international taxation more transparent, to ensure clean competition and to prevent double taxation. Two of such steps are the creation of the OECD’s Base Erosion and Profit Shifting (BEPS) program and the State aid investigations of the European Commission. These two measures will affect the word of international taxation significantly and being up-to-date in these topics is really important for people working in this area.

Considering the above, I decided to examine the cross-border tax ruling investigations of the European Commission. First I want to give a general background for the understanding of the reasons of the investigation and to describe the criteria which shall be met for a negative decision. Having that background, I want to show through one of the company investigated how these criteria are assessed in practice by the Commission. I chose Starbucks as its case is already analyzed by many tax specialist and because it’s the first transfer pricing based tax ruling investigated. The main question of my thesis is whether the investigation opened by the European Commission is legally well grounded as regards of the selectivity criterion of Article 107 TFEU and what outcomes it can have.
2. General background

In this part I want to provide a general background which is necessary for the understanding of the taxation questions arising in connection with the Starbucks case. The most important is the State aid investigation procedure of the European Commission, but tax rulings, transfer pricing and intangible properties are also such concepts which we have to know to understand the process.

2.1. EU State aid

The European Union was created based on certain basic principles. The free movement of capital, labour and goods are commonly known, but the ways how they are ensured is not so clear for everyone. Inter alia, the EU requires equal treatment from member states regarding all companies. The European Single Market, one of the EU’s main goals, can be achieved only if countries don’t try to grant economic advantage for a certain group of companies, otherwise they would help their own firms on the expense of foreign ones.

According to the Article 107 of the Treaty on the Functioning of the European Union (TFEU), “Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.” The application of the rules is the responsibility of the European Commission, primarily the Directorate-General (DG) for Competition.

2.1.1. Rulings

According to Article 107 of TFEU, not only a given amount of money can be considered state aid but economic advantages given through tax rules and methods. State aid disciplines has been applied by the Court of Justice of the European Union (‘CJEU’) to tax measures since the Treaty of Rome has been created, but their use in practice was really rear for decades. The difficulty of the application comes partly from the fact that it requires intervention from the Commission in a sovereign area of Member States. In this respect a change had been made in the nineties, since then the Commission decided to apply state aid law more often and systematically. (Micheau, 2014).
In 2013, the European Commission started to investigate the so called cross-border tax rulings. A tax ruling is an assurance offered by – depending on the country - the Member State’s tax authority or one of its ministries, which helps the tax payer secure the foreseeable tax effects of its given transactions. When claiming a tax ruling, the tax payer outlines its transaction in question for the tax authority / ministry, presents the corresponding laws and their use in practice, and delineate the expected tax liability derived from the foregoing. After reviewing the request, the tax authority / ministry decide to decline, ask for additional documents or accept it. In case of acceptance, the tax payer cannot be penalized during a tax inspection for the given transactions, if the transactions are implemented in accordance with the tax ruling. Tax rulings are provided by many Member States for the companies, however there’s no specific description of them and therefore they are different in the different countries. Hence it occurs for instance, that while they are provided for a given period in one country, this period is not specified in the other. Thanks for the rulings the taxpayer can insure itself with respect to its bigger and/or riskier transactions while the tax Authority / ministry i) receive money for the process and ii) make the country more attractive for some investors due to the safety in taxation they provide (Givati, 2009).

Tax rulings as such are insofar not problem for the European Commission, as long as they are provided and used for their original goal, namely to serve as an assurance for the companies that their operation is compliant and hence they are protected against a tax penalty. However, some of the tax rulings ensure selective tax advantage for some of the undertakings, distort competition within the EU and violates its state aid related rules.

If the European Commission concludes about a ruling that it’s an illegal state aid and hence it violates EU rules, the Commission order for recovery and compound interest on all aid received. In case of disagreement, both the country providing the ruling and the company receiving the ruling can decide to appeal by the Court of Justice of the European Union. If the Court’s decision confirm the Commission’s standpoint, Member States are compelled to recover aid directly from recipient undertakings and the domestic law restrictions will not apply to limit recovery (Commission, a).
2.1.2. Investigation procedure of the COM

State aid provided by Member States shall be notified to the Commission beforehand. The Commission has then two months to decide, whether i) there is no aid and the measure can be applied, or ii) the positive effects of the measure outweigh the negative ones, hence it can be implemented, or iii) serious doubts arise regarding the measure, and the Commission opens an in-depth investigation. In the latter case, measures shall not be applied before the end of that process (formal investigation procedure). Prior notification of the Commission and waiting for the decision before implementing a state aid is compulsory for states, however there’s some exceptions to mandatory notification, such as aid covered by a Block Exemption, de minimis aid not exceeding €200 000 per undertaking over any period of 3 fiscal years (€ 100 000 in the road transport sector) or aid granted under an aid scheme already authorised by the Commission. The Commission is obliged to open a formal investigation under Article 108(2) TFEU where it has serious doubts about the aid's compatibility with EU State aid rules, or where it faces procedural difficulties in obtaining the necessary information. The relevant Member State will be informed through an official letter about the decision to initiate this procedure. (Commission, a)

In case of an investigation regarding to a tax ruling, the decision starts with the presentation of the procedure in question, listing the emails, information requests and letters which were sent the Commission by the Member State. Thereafter comes the description part. At first, an introduction to the taxation background is made, which is important not just to make the reader able to understand the case easier, but the Commission shall specify the “normal taxation method”, from which the method enabled by the ruling is different. It’s followed by the description of the beneficiary: the company’s background, revenues and other relevant financial data during the investigated period, the taxes it paid in the country and the relevant corporate structure. Next, the method followed by the taxpayer is presented, during which the contested measures is highlighted. Then comes the assessment, in which the Commission qualifies the measure as aid within the meaning of Article 107(1), which requires the demonstration that the following conditions are met: (i) the measure is made through state resources; (ii) an economic advantage is secured by the measure; (iii) the measure is selective, i.e. it distinguish certain undertakings and (iv) it must distort or threaten to distort competition, hence it influences trade on the EU’s single market. After the presentation of the above
and the determination of aid, the Commission takes a view on the criteria according to which the measure could be considered as an aid compatible with the internal market.

State aid measures can be considered compatible with the internal market on the basis of the exceptions listed in Article 107(2) and 107(3) TFEU. Article 107(2) lists aid which shall be compatible with the internal market: aid having a social character, granted to individual consumers, aid to make good the damage caused by natural disasters or exceptional occurrences and aid granted to the economy of certain areas of the Federal Republic of Germany. Article 107(3) lays down measures, which are considered to be compatible with the internal market: aid to promote the economic development of areas (provided that certain requirements are met), aid to promote the execution of an important project of common European interest, aid to facilitate the development of certain activities, aid to promote culture and heritage conservation and such other categories of aid as may be specified by decision of the Council on a proposal from the Commission.

The last part is devoted to the Commission’s decision. A request is made to the challenged Member State to submit comments on the case and to give such information within one month which can help during the assessment. The authority is asked to send a copy of the Commission letter to the beneficiary of the aid and remind the state to the relevant legal background. Furthermore, the Commission draws the Member State’s attention to the fact, that the letter will be published in the Official Journal of the European Union and in case of the letter would contain confidential information, the member state has 15 working days to inform the Commission and require the exclusion of such information.

2.1.3. Assessment of conditions to be met

When assessing a measure and deciding whether it’s considered state aid under Article 107 TFEU, the Commission has to investigate whether an undertaking has received a selective advantage due to the measure. Moreover, this advantage shall be financed through state resources and distort competition to meet the criteria of state aid. The following part is devoted to the clarification of these conditions which has to be fulfilled for the determination of illegal state aid given by a Member State.
Undertakings

According to the Court of Justice, legal status and the way in which they are financed is not decisive when defining the term undertakings, only their engagement in an economic activity\(^1\). Therefore, as a general principle, classification of an entity depends entirely on the nature of its activities. Three consequences can be derived from that principle:

i) The status of the entity under national law is not decisive (i.e. associations or sport clubs can be regarded as undertakings according to Article 107(1) TFEU).

ii) The application of the state aid rules does not depend on whether the entity is set up to generate profits (non-profit entities can offer goods and services too).

iii) Classification of an entity is relative to a specific activity. If both economic and non-economic activities are carried out by an entity, it is to be regarded as an undertaking only with regard to the former.

Economic and non-economic activities can be distinguished as the following: any activity consisting in offering goods and services on a market is an economic activity\(^2\). When determining whether economic activity exist or not, the exclusion of other parties by a public authority is not decisive: an economic activity can exist where other operators would be willing and able to provide the service in the market concerned. (Commission, 2014)

State origin

According to Article 107(1) TFEU, “any aid granted by a Member State or through State resources in any form” can constitute State aid. The Commission’s main point of view is that as the state has influence on tax and can spent money coming in the form of tax, state resources criterion is met in the case of loss in tax due to the measure. This applies also to regional or local public bodies too\(^3\). However, even if they are often treated jointly, in practice the CJEU distinguishes the granting of an advantage directly or indirectly through State resources and the imputability of such a measure to the state. In other words,

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\(^1\) Joined Cases C-180/98 to C-184/98 Pavlov and Others (2000)

\(^2\) Case 118/85 Commission v Italy (1987); Case C-35/96 Commission v Italy (1998)

\(^3\) Case 248/84 Germany v Commission (1987)
there’s difference between the loss of tax income due to the measure and the state’s influence in the application of the measure\textsuperscript{4}. Due to the close relations between public undertakings and state, an aid given to an undertaking by a public authority may easily be categorized as imputable to the state, even if that public authority enjoys autonomy\textsuperscript{5}. As regards the direct or indirect state resources, the Commission investigates the state’s ability to influence the use of given resources.

**Economic advantage**

Economic advantage must be granted by a measure to be categorized as state aid under Article 107 (1) TFEU. That advantage shall be compared to the normal market conditions, i.e. the Commission has to show what financial situation the beneficiary would have reached without state intervention, and what situation it has really achieved. When assessing the advantage given by a measure, the CJEU “does not distinguish between the measures of state intervention concerned by reference to their causes or aims, but defines them in relation to their effects”\textsuperscript{6}. That effect can take many form, so not only a positive amount in the undertaking’s financial statements, but a relief from economic burdens, i.e. the avoidance of a negative item too. Inter alia, an economic advantage can take the form of a reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements or the entering of reserves on the balance sheet), a total or partial reduction in the amount of tax (such as exemption or a tax credit), deferment, cancellation or even special rescheduling of tax debt (Commission, 1998). Moreover, the mere fact that undertakings are in a better position in other Member States because those states apply lower rates, fees, etc., does not rule out the existence of an advantage, as only the undertaking’s own legal and factual context is important in this respect\textsuperscript{7}.

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\textsuperscript{4} Case C-482/99 France v Commission (Stardust) (2002)
\textsuperscript{5} Case C-482/99 France v Commission (Stardust) (2002), paragraph 53.
\textsuperscript{7} Case T55/99 Confederación Espanola de Transporte de Mercancías v Commission (2000), paragraph 85.
Effect on trade and competition

Distortion or the threat of distortion of competition and the effect on trade between member states are also criteria of state aid under Article 107 (1) TFEU. However these are different criteria, but they are often considered together as “concerning state aid, the conditions under which trade between member states is effected and competition is distorted are as a general rule inextricably linked”\(^8\). When assessing these criteria, the Commission shall consider not only the market conditions at the time of granting the advantage, but also it shall count with the foreseeable effects of the measure. For instance, the Court of Justice accepted in one of its judgment that the aid granted to an undertaking satisfies these conditions even if the undertaking’s exports outside the Community accounted around 90% of its turnover at the time of adoption of the contested decision, because “it was reasonably foreseeable, that it would redirect its activities towards the internal Community market”\(^9\). That judgment also shows, that export trade outside the EU may also influence the EU Single Market, therefore any aid given for such activity may be considered as state aid. Furthermore, it’s also not relevant in this respect when the aid is granted to an undertaking which operates only in a region and thus not directly involved in cross-border trade, because that may make it more difficult for other companies to enter the market by effecting local supply\(^10\). The definition of the market or the detailed investigation of the measure’s effect is not necessary for the establishment of distortion of competition or effect on trade, as the Commission only assesses whether the measure is liable to affect trade and threatens to distort competition\(^11\).

Selectivity

Selectivity criterion of Article 107(1) TFEU wins great importance during the cross-border tax ruling investigation of the Commission, as it may be pretty hard to prove in this respect and as such, it may give a good possibility for the companies and states involved to protect their own point of view. According to Article 107(1) TFEU, “certain undertakings or the production of certain goods” shall be favored by a measure to be considered as state aid. That means, that no distinction between undertakings shall be

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\(^8\) T-298/97 Alzetta and Others v Commission (2000), paragraph 81
\(^9\) Case C-142/87, Belgium v Commission (the Tubemeuse judgment), paragraph 35. to 40.
\(^10\) Case C-280/00 Altmark Trans (2003), paragraph 78.
applied by any of the member states, regardless of the number of undertakings involved by the measure, even if it’s a whole sector. Practically, any measure made must be available to all sectors. However, even if the measures are made in an objective manner, selectivity may arise due to their real effect.

Two types of distinction is worth to make regarding selectivity. The first one is the difference between geographical and material selectivity. In case of geographical selectivity, companies having economic present (e.g. through a permanent establishment) in a specified geographic area are handled different than others. In general, the scope of measures made by a Member State should be the entire territory of that state. However, some exemption can be made, such as symmetrical or asymmetrical devolution of tax powers, where regional or local authorities has the power to adopt tax measures and tax rates within their territory. There’s three types of autonomy in this respect: institutional, procedural and economic autonomy. Institutional autonomy means that tax measure decision can be made by the local authority within its own institutional, political and administrative status, which is separate from the central government. Procedural autonomy exist if tax measures can be adopted without the central government being able to intervene. For economic and financial autonomy, local or regional authority shall be responsible for the political and financial effects of tax measures (Commission, 2014).

Material selectivity means that a measure has effect on just certain undertakings, groups or sectors of the economy. That can be reached in two ways: de jure or de facto. When the selectivity is de jure, then distinction can be derived from the legal criteria of the tax measure in question. For instance, this is the situation when the companies’ size, activity in a sector, management or owner, incorporation date or other such feature is relevant for obtaining an advantage or avoiding a negative tax measure. In this respect, the Court of Justice determined that “that neither the large number of eligible undertakings nor the diversity and size of the sectors to which those undertakings belong provide any grounds for concluding that a State initiative constitutes a general measure of economic policy”.

Establishment of de facto selectivity may be tougher, as in this case not the legal text itself what causes a difference in the handling of undertakings, but the real effect it has on them. That may occur for example when despite the objectivity and generality of the

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12 Case C-143/99 Adria-Wien Pipeline (2001), paragraph 48.
13 Case C-143/99 Adria-Wien Pipeline
criteria, considering the given country or one of its sector, the measure has a (significantly greater) effect only on undertakings with a certain group of owner.

A three-step analysis is applied by the Commission for the determination of selectivity. First, a reference system must be identified, otherwise there’s nothing the measure could derogate from. This reference system is mostly the national laws, but sometimes the Commission grounds its decision on other type of reference system, e.g. on international standards in the Starbucks case. As a second step, the derogation itself from that reference system shall be identified, which can be made for example through the calculation of the beneficiary’s financial situation with and without the measure in question. If there’s a definable reference system from which the measure really derogates, it still has to be established as a third step, whether this derogation is justified by the general scheme or the nature of the (reference) system. In case of the derogation is justified by the above, the measure is not selective according to Article 107 (1) TFEU (Micheau, 2014).

2.1.4. Automatic information exchange

As part of its initiation against tax avoidance and harmful tax practices the European Commission has made a proposal on 18 Marc 2015, according to which member states shall be liable to exchange information automatically every quarter regarding rulings and APAs to each other and to the European Commission (APAs are close the same as rulings just they are asked for the confirmation of the compliance of prices used in a given transaction). This obligation would not apply to rulings concerning only one state and rulings given to individuals. According to the initiation, shared information should contain the name of the taxpayer and its group, the content of ruling/APA, the criteria used during transfer pricing and the member states and taxpayers which are expected to be concerned by the ruling/APA. Commercial, industrial or professional secrets, trade processes or such information, which disclosure would against the general rules don’t form the part of information to be shared. Member states would be furthermore entitled to require additional information, even the complete text of the ruling in question. However, the European Commission will not be entitled to receive the concrete information mentioned above. Its role is to ensure that the information exchange takes place indeed and the process is uninterrupted. Therefore, based on the authority it receives
through the directive, the Commission will create other practical instruments (eg. information form).

The modified version of the above initiation was accepted seven month later by ECOFIN, and it’s intended to be carried into effect as a modification of 2011/16/EU, an already effective directive on administrative cooperation in the field of taxation and repealing. According to the Commission’s initiation in March, the automatic information exchange should have been made by the member states regarding to the rulings and APAs given in the last 10 years (Council Directive Proposal, 2015). That has been changed and reduced to only 5 years. More specifically: Cross-border rulings and APAs received, modified or renewed after 31 December 2011 fell under the scope of the new rules, provided that they are effective after 1 January 2014. Rulings and APAs received, modified or renewed between 1 January 2014 and 31 December 2016 fell under the scope of the directive regardless to their effectiveness. Practically, all the rulings and APA-s received, modified or renewed after 31 December 2013 are to be handled according to the new rules.

As an acknowledgement of the immense amount of work coming from the new directive, member states have the right to leave out such rulings and APAs from the automatic information exchange, which were given to firms having annual income on group level less than 40 million EUR in case of the ruling or APA was given, modified or renewed before 1 April 2016. However, rulings or APAs given to firms with a main activity of financial or investment services cannot be excluded. Rulings and APAs given after 1 January 2017 are always affected by the new directive and information about them shall be shared within 3 month after issuing them. Information about other decisions mentioned above shall be exchanged until 1 January 2018 at latest. The European Commission intends to cooperate with OECD and highlights the importance of the standards established by the organization in connection to the topic. (Council Directive, 2015)

The European Council, as the main legislative organization of the EU, finalized the detailed directive on December 2015. The directive is in line with developments within the OECD and its work on tax base erosion and profit shifting and shall be applied from 1 January 2017. (Council, 2015)
2.2. Transfer pricing

Transfer pricing refers to the prices used in transactions between different entities of a corporate group. The method how these prices are calculated is important as they form the part of the corporate income tax base and so their use can be a way to profit allocation between the group firms. Charging higher than normal prices for group members in high tax jurisdictions for goods or services ordered by a group member from a low tax country drive to lower consolidated tax burden.

The above gives rise for two problem. First, countries having high tax rates lose income in favour for the low tax states, which puts pressure on them and leads to competition in taxation. However, the need for tax income of the countries will not be lower, so they have to use higher tax rates by tax types not so competitive, which means that the tax rates cannot be determined based on solely economic decisions. Furthermore, as states having economic advantage because of this competitive taxation system will try to keep that advantage, the harmonization of the system is very difficult and time-consuming and gives significant power for these countries during negotiations. Second, inappropriate transfer prices distort competition between enterprises, because companies having economic presence in only one country or being not big enough can’t use the same tax base decreasing methods.

Therefore, the use of appropriate transfer pricing method is essential. The internationally agreed standard for setting such commercial conditions between companies of the same corporate group or a branch thereof and its mother company and thereby for the allocation of profit is the “arm’s length principle” as set in Article 9 of the OECD Model Tax Convention and in the OECD Transfer Pricing Guidelines, according to which commercial and financial relations between associated enterprises should not differ from relations which would be made between independent companies.

When evaluating transactions from a transfer pricing aspect, we shall begin with the identification of the participant firms. That should contain the analysis of the whole corporation’s main activity, the markets in which it has economic present, the affiliated companies of the group between whom the transaction in question was made and their role in the group. After receiving the first picture, we shall identify the risks taken by participants of the transaction. Risk plays an important role in transfer pricing, since as a principal in finance, the expected return of an investment is based on the risk we expect.
to take with that investment. In other words, assuming normal economic conditions, one would take higher risk only if he expects higher return on his invested money. Having normal supply and demand, prices of goods and services between independent firms (arm’s lengths price) will find a balance where they reflect the risks taken. As such, the same can be expected from affiliated firms too when establishing the terms and conditions of their contracts. (OECD, 2010)

There’s a really interesting asset in transfer pricing: intangibles. Even their definition is difficult, as it can easily contain too much or not enough items, which has an effect on their compensation. As it’s recommended by OECD BEPS Action Plan 8-10, “the word “intangible” is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.” (OECD, 2015).

Besides to the difficulty of their definition, there’s two more problems with intangibles: they are really hard to value and pretty easy to move. Companies like these two characteristics because they make it easier to allocate profit between countries, mostly from high tax countries to low tax jurisdictions. For instance, considering a multinational enterprise operating in many countries, it can easily replace its royalty into a state with minor tax burdens which gives then the right to use these royalty for other group members in high tax countries. In this case, the group tires to over evaluate the price of the royalty and the payment for its use. Due to the fact, that there’s almost no intangibles with the same features, the tax authority is hardly able to find a comparable price and they likely to accept the estimated price. As a result of this method, the company wins not only the possibility to pay less tax on the intangible itself but other income generated by other assets in the high tax country can be allocated to the low tax country through the use of that intangible.
3. Starbucks

Starbucks is a Seattle based roaster, marketer and retailer of specialty coffee. Their activity covers purchasing, roasting and selling of coffee with special tea and food through company-operated stores as well as through licensed stores, groceries and national foodservice accounts. The Company’s story began in 1971, when they were a roaster and retailer of whole bean and ground coffee, tea and spices with a single store in Seattle’s Pike Place Market. Following the success of the first years, Starbucks Corporation was incorporated in 1985. Their common stock is listed on NASDAQ, under the trading symbol SBUX. According to their financial reports, they have more than 22 000 retail stores in 67 countries today and their total net revenues and operating income has reached USD 19 billion and 3.6 billion respectively in FY 2015.

3.1. State aid investigation against Starbucks

During its State aid investigation the European Commission requested the Dutch authorities on 30 July 2013 to provide information regarding the tax ruling practice in the Netherlands. The scope of that investigation covered also the Netherlands based entities of the Starbucks Corporation, i.e. Starbucks Coffee EMEA BV (“SCBV”) and Starbucks Manufacturing EMEA BV (“SMBV”). Following the investigation, the Commission had doubts about the comparability of the tax method followed by the Netherlands in its APA given to SMBV (“SMBV APA”). In line with the usual investigation procedure, an official letter was sent to the Netherlands in which the Commission stated that “The present decision is without prejudice to the 2008 APAs insofar as those APAs relate to the structure Starbucks Coffee BV. As regards that structure, the Commission has not at this stage identified comparable doubts. However, the economic rationality of this structure is not straightforward and the Commission reserves the right to conclude its assessment once it has completed the present formal investigation” (Commission letter, 2014). Therefore, the Commission decided to initiate the procedure laid down in Article 108 TFEU, i.e. the Netherlands was requested to submit comments on the investigation. However, the Dutch comments were not enough to convince the Commission about the comparability of the SMBV APA, thus the Netherlands was required to recover the aid with interest from Starbucks.
Taking into account that these information would be otherwise confidential, the Commission’s letter about its decision, which contains information about the connections between the group members in the Starbucks group, their agreements and the APA which was given to SMBV by the Netherlands, is a unique source to show how transfer pricing and intangible properties are used in the practice for profit allocation. According to this letter, SCBV and SMBV are in a fiscal unity together and paid taxes in the Netherlands in amount of EUR 715 876 in 2011 and EUR (600 000 – 1 000 000) in 2012 and employed 97 and 79 employees respectively in 2011. Starbucks Coffee BV is the head office for the EMEA region having several license agreement. Related and unrelated Starbucks shops are able to use trademarks, shop format and corporate identity through the licenses of SMBV.

Starbucks uses a system in which all the companies operating a Starbucks shop pay a royalty for the coffee supply and a royalty for the use of IP. Regardless of their related or unrelated status, these companies pay the same royalty. These royalties are paid to Starbucks Coffee BV which holds these intellectual property (IP) rights in license of Alki LP, one of its affiliated party, against payment of a royalty.

Starbucks Manufacturing BV is an Amsterdam-based roasting facility of the group, which is the only coffee roasting company in the Starbucks group in Europe. SMBV licenses IP from Alki LP through SCBV, which IP is important for the production and delivery process of coffee. In return for this IP, SMBV pays royalty to Alki LP (through SCBV). Coffee beans for the roasting activity are supplied by a Swiss subsidiary of the group, which buys those beans for the entire Starbucks group. After the roasting and packaging process made by Starbucks Manufacturing BV, these beans will be transported to warehouses in the Netherlands.

Alki LP is a UK limited partnership. Without having an exact definition it can be generally said, that partnerships are an association of two or more persons for the purpose of making profit from which the members are entitled for their shares with respect to proportions determined beforehand. Partnerships may or may not have legal personality, which depends on the law of the country of organization. Usually partnerships can be created by individuals and legal persons too. In taxation, partnerships can be fiscally transparent or separate taxable entities. Fiscally transparent partnerships are merely an accounting unit from a tax point of view and as such, they are not liable to tax in the country where it’s established. In that case, income generated by the partnership flows
through to the partners and will be taxed on the partners’ level. If a partnership is treated as a separate taxable entity, the income generated by the partnership is liable to tax on the partnership level (Nieminen, 2013). From a Dutch tax point of view, Alki LP is considered to be a transparent entity and as such, the royalty payment from Starbucks Coffee BV to Alki LP for the use of IP is considered to be a direct payment to Starbucks US from a Dutch tax perspective.

3.2. Transfer pricing method followed by Starbucks

The use of a proper transfer pricing method is essential for the avoidance of profit shifting and artificial tax burden allocation between countries. Having significantly different corporate income tax rates and tax base increasing / decreasing items in the states, it worth a lot for multinational companies to create such a company structure, which ensures the most optimal taxation for them. Even if the broadly accepted international taxation principles try to obstruct the use of artificial elements in these structures, the competition between countries and the greatly complex world of business makes it really difficult to stop firms using them. As the Commission’s decision is largely based on the inappropriate transfer pricing method followed by Starbucks Manufacturing BV, the Commission’s letter to the Netherlands contained a significant part in which it described transfer pricing itself and the way in which it was made by SMBV.

The European Commission has challenged Starbucks Manufacturing BV because of its APA concluded with the Dutch tax authority in 2008. Align with Article 8b of the Dutch Corporate Income Tax Act of 1969, international standards in this area and the OECD guidelines, the APA was made to secure the arm’s length remuneration of SMBV for the services it provides and for the services and goods it buys (e.g. coffee beans). SMBV used the transactional net margin method (TNMM) in this APA because they kept it less affected by transactional differences and functional differences. With the use of the TNMM, a mark-up of 9-12% on the relevant cost base was determined as a proper remuneration for the company’s activity. The relevant cost base is the costs to which SMBV itself adds value.

According to the OECD Guidelines, the TNMM “examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled
transaction. (...) In order to be applied reliably, (...) the net profit indicator of the taxpayer from the intra-group transaction should ideally be established by reference to the net profit indicator that that same taxpayer earns in comparable transactions with independent companies. (...) Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide. A functional analysis of the intragroup and independent transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.” (OECD, 2010) Such a functional analysis is made to determine, measure and compare the economically significant activities, responsibilities and risks in a given transaction.

The Amsterdam-based roasting facility was identified by the functional analysis as the main place of activity of Starbucks Manufacturing BV. The roasting activity’s main raw material is green coffee beans which were supplied by a Swiss group entity. Besides its roasting activity, SMBV perform supply chain operations, which means that the company is responsible for the material requirements planning, sourcing, buying and distribution too. According to a supply agreement between SMBV and retailers, pricing formula can be revised periodically by SMBV. Furthermore, the company is entitled to set invoicing and payment terms. In return for these entitlements, SMBV is agreed to supply its products free of defects. Defected goods will be replaced, which means that the company bears product related risks. But not only the roasting activity of the firm was identified by the transfer pricing document, but its role as an operator of intermediary distribution network too. This network is used for the distribution of a variety of non-coffee items, e.g. napkins, cups and equipment.

When applying the TNMM to the manufacturing activities of SMBV, the costs of services were chosen as the relevant base for the net profit indicator. According to the Commission’s letter, it is an appropriate method for supply chain and manufacturing services. However, only such costs should be considered in this respect for which the company adds value. Inter alia the following such costs were listed in the transfer pricing report: cost of the facility, cost of production equipment, personal costs engaged in both manufacturing and supply chain activities. On the other hand, the sourcing of green coffee beans was considered as a cost which is not controlled by the company. Only the inventory and roasting risks were considered as costs under the firm’s control. Moreover, those non-coffee costs of the company which are related to its intermediary distribution
activity (approximately 50% of SMBV’s costs), are also excluded from the cost base. Finally, a part of the firm’s cost was categorized as so called tolling fees (approximately 10-20% of SMBV’s cost), i.e. such fees which are related to intermediary activities of the firm (e.g. consignment manufacturing agreement and agreement with third-party logistics/distribution service providers). As SMBV acts only as an intermediary in these agreements, these cost were also excluded from SMBV’s cost base. Moreover, two another adjustments were made in the transfer pricing document stating that they are necessary to obtain the price which would be used by independent parties. As a result of these exclusions from the cost base, SMBV’s cost base and the net profit expected from the company were significantly reduced.

Most of these reductions and adjustments were based on the assumption that SMBV can be classified as a low-risk toll manufacturer. A toll-manufacturer is a manufacturer which performs only few activities. Besides the economically reasonable situations, they are also created due to tax planning purposes as they are a good instrument for risk allocation. Such a risk allocation can be made through agreements, according to which the toll-manufacturer perform only manufacturing activity, but the purchase of raw material and sales are the responsibilities of another group members. Finished products will be typically put in consignment in the premises of the manufacturing company. In this case, because of the low level of risk at the toll-manufacturer company, the remuneration of that group member can be kept very low. However, according to the agreements and financial statements SMBV sent to the Commission, not only the negotiation of commercial conditions for suppliers and price setting determination for the shops were included in SMBV’s activities, but the company was also responsible for the damage of inventory and finished products too.

However, the Commission challenged not only the toll-manufacturer classification used by SMBV, but the royalty it paid to Alky LP for the use of its IP. All the items in Starbucks Manufacturing BV’s profit and loss statement were (or assumed to be) arm’s length. As the only exception, the royalty was calculated as a residual and not as a remuneration for the IP. According to the SMBV APA, the company’s net profit should be around the 9-12% of its operating expenses. However, after all other income and expenditures items, SMBV had to make a correction in its profit and loss statement to fulfill this criterion. This correction was made through the royalty, which fluctuated heavily from year to year but it was always the amount which was needed to push down (or even up, through a
negative payment) the net profit margin of the company. As the Dutch tax authority could not justify the reason of this fluctuation, the Commission concluded that the price of the royalty paid to Alki LP cannot be considered arm’s length.

Due to the above, the APA provided to SMBV has artificially lowered its tax base in the Netherlands in two ways: the company paid an inflated price to its Swiss affiliated company and paid a price for the use of Alki LP’s royalty which soaked up all the remaining profit above that lowered profit expected by the APA (Press release, 2015). However the Commission does not mention in its letter or in its press release because they cannot challenge that part of Starbucks taxation method, but it worth to mention, that due to the taxation transparency of Alki LP in the UK, the royalty paid to Alky LP leaves the EU without being taxed.

3.3. State aid procedure in the Starbucks case

As written in 2.1.3., the qualification of a measure as aid within the meaning of Article 107(1) requires the following cumulative conditions to be met: (i) the measure must be imputable to the State and financed through State resources; (ii) it must confer an advantage on its recipient; (iii) the measure must distort or threaten to distort competition and have the potential to affect trade between Member States; and (iv) the advantage must be selective.

In the Starbucks case, the first three criteria are easily fulfilled. The SMBV APA was issued by the Dutch tax authorities, which is the part of the Dutch State. The state could easily terminate the issuance of such APAs, so the state is fully liable to the tax measures caused by them. Furthermore, the Commission showed that Starbucks Manufacturing BV had to pay less tax in the Netherlands due to the SMBV APA as it should have without this APA, which fulfills the economic advantage through state resources criteria. As regards distortion of competition and the effect on trade: Starbucks Manufacturing BV is a multinational corporation operating on the liberalized markets of various member states which means that an economic advantage granted to the firm will potentially affect trade between member states through supply. However, the fourth condition – selectivity – is more complicated and gives rise to many question, therefore it worth to investigate the fulfillment of this criterion deeper.
Selectivity

As written above, tax measures applied by a member state shall distinguish taxpayers in some way to create state aid according to Article 107(1) TFEU. That selectivity may sometimes be pretty hard to prove, as their selective manner can often be derived not from the text of the measure itself, but from the effect they have on the competitive status of certain undertakings of the given market. In spite of the numerous judgments made by the Court of Justice of the European Union in this regard, the practice itself seems always to generate new legal rules or other measures which give rise to many question. The cross-border tax ruling investigation driven by the European Commission is one of them as it monitors tax practices that have been followed by national authorities for years but which were never in the scope of the CJEU’s decisions before. What makes these tax practices really hard to challenge is that they are based on a kind of a bilateral agreement made between the authorities and the tax payer which is confidential in many cases. The importance of these agreement is out of question, and their use as it is now would be hard to criticize as they are essentially just an early debate between the parties involved which would be otherwise made during a tax inspection\textsuperscript{14}. For example, during a tax investigation in Hungary, the tax authority assesses the taxation method followed by the taxpayer and if there’s any discrepancy between the followed method and the method considered by the authority as the legal one, a debate is initiated. This debate is made only between the tax authority and the taxpayer at first and at second instance. In lack of consensus the Parties may engage in a court procedure. The content of these debates are known only for the participants, i.e. they are confidential and undisclosed.

When deciding about a tax ruling request, the authority must understand the outlined method which would be followed by the tax payer, assess it based on the relevant legal background and decide whether the outlined method is in line with the relevant laws. That means, that during a tax ruling investigation, the Commission has to give an opinion not only about the text of the tax measure or the effect it has on the undertakings, but on the decision of the authority of an autonomous state as well.

As mentioned above, prove of selectivity requires the determination of a reference tax system from which the method in question differs and the derogation itself from that system. However, question arises whether is that reference system has to contain only

\textsuperscript{14} Commission Decision 2011/276/EU of 26 May 2010 on State aid C 76/03, Umicore SA, recital 153
measures made by the state (e.g. laws) or can it have a broader range. Despite of the many judgments made by CJEU in connection to state aid, this question has never been answered, as the challenged measures’ basis was always a national law. International standards like the OECD Guidelines have always been used only as additional background for the understanding\textsuperscript{15}. Taking into account the above, the Starbucks case opens a great possibility for debates. Directives of the EU are binding for the member states and they have to take them into account when creating a tax measure, tax rulings questioned by the Commission are sometimes based on international standards and not on obligatory laws or directives. For example, the Commission has the following doubts as regards compliance of the SMBV APA with the arm’s length principle\textsuperscript{16}:

- Whether the Dutch tax authorities correctly accepted Starbucks Manufacturing BV’s classification as a low-risk toll manufacturer when it concluded the SMBV APA with that undertaking;
- Whether the Dutch tax authorities were right to accept the first and second adjustments made by Starbucks Manufacturing BV’s tax advisor when it concluded the SMBV APA with that undertaking; and
- Whether the Dutch authorities were right to accept Starbucks Manufacturing BV’s interpretation of the SMBV APA as regards the calculation of royalties in its P&L, insofar as the level of those royalties is not linked to the value of the IP in question.

The above doubts are highly based on the implementation and application of the OECD Guidelines in the Dutch taxation system and on their understanding by the Dutch tax authority. In this respect, the letter from the Commission to the Netherlands says “According to Article 8b of the Dutch Corporate Income Tax Act 1969 (Wet Op de vennootschapsbelasting 1969) and in accordance with international standards in this area, in particular the OECD Guidelines,…”, but the cited part of the Dutch tax law does not contains reference to the OECD Guidelines. In fact, that part of the Dutch CIT Act says only, that transfer prices applied between affiliated parties shall be the same as it would be between independent parties in the same transaction. Having regard that the Commission refers almost only to the OECD Guidelines afterwards, question may arise

\textsuperscript{15} http://ec.europa.eu/competition/consultations/2014_state_aid_notion/draft_guidance_en.pdf

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whether the Commission expect the compliance of the Dutch tax rulings with recommendations not binding for the Dutch state.

But, there is another approach of selectivity. That is, when “the tax measure is assessed by comparison with other undertakings in similar situation” (Michaeu, 2014). This approach seems not to highlight the importance of determination of a reference taxation system, but intends to prove the different treatment of undertakings by the authority on the basis of how other undertakings are handled. Provided that – due to the above reasons – the reference taxation system based selectivity test does not seems to be well grounded enough, the application of that second approach may give us solution for that problem. However the SMBV APA has been investigated by the Commission almost only with the first approach, they were also provided with information regarding other companies which received APAs from the Netherlands. According to the Commission’s decision released, these documents contained one APA to a toll manufacturer with a toll manufacturing agreement attached, which could be taken as basis for such a selectivity test. That contract was made between a Swiss and a Dutch entity of the same group, where the Swiss entity operated as the principal and the Dutch entity as the toll manufacturer in that contract. The following differences compared to the SMBV APA were highlighted by the Commission as indicators of selectivity:

- Raw materials and any work in progress remain the property of the Swiss entity;
- The Swiss entity provide insurance to the Dutch entity for any replacement costs of raw materials;
- The arm’s length remuneration is based on a comparison of average return on assets where no adjustment is made;
- The toll manufacturer company has low level of inventories compared to the other assets.

However the above written characteristics of the agreement chosen for comparison are truly differ from the SMBV APA, but it only gives rise to more question. Even if it would be accepted that the Dutch authority has decided differently in these two APAs, it would not be proved in the absence of a reference tax system that the SMBV APA is the unique APA and the other is the normal one, i.e. the use of solely one APA is hardly enough for a comparison. However, it could be asked than, that how many comparable case should be fined for a well based decision? Following this logic, wouldn’t we go back again to
the problem of the reference system? This comparable APA is referred by the Commission to prove that SMBV’s classification was incorrectly accepted as toll-manufacturer in its APA, but even if the CJEU accept that, it does not answer how to ‘remake’ the agreement to be compliant and the (according to the Commission) inappropriate use of royalty is not even concerned.

In the light of the above, it may worth to cite parts of the Cabinet Response to the European Commission Decision on Starbucks Manufacturing BV: “In its decision, the Commission uses its own interpretation and application of the OECD guidelines about the transfer pricing methods, with the result that, according to the Commission, the so-called Comparable Uncontrolled Price (CUP) method should have been applied. The Dutch government does not believe that the CUP method should have been applied in the Starbucks case because of the absence of suitable data. Moreover, in its decision, the Commission applies its own new criterion for profit calculation, which is incompatible with domestic regulations and the OECD framework. The Commission states in its Starbucks decision that the arm’s length principle applied here is not the same as the arm’s length principle stemming from Section 9 of the OECD treaty. This causes confusion and uncertainty. For the Tax Authorities such uncertainty relates to the question of what rules are to be applied in which fashion. And for enterprises, such uncertainty relates to the proper application of rules in rulings. So as to obtain more clarity and jurisprudence in this matter, the Cabinet appeals the decision. (…) The Cabinet believes the Commission has failed to convincingly prove that the Tax Authorities deviated from statutory regulations and that State aid was provided.” (Cabinet Response, 2015)

Further reactions

Many parties are concerned by the State aid investigation of the Commission regarding tax rulings and APAs, and as such, it triggers a lot of debates. The tax system of the United States has – broadly speaking - followed the logic so far, that a big part of US corporate income could avoid taxation as far as it’s not repatriated. An advantage has been secured to US firms using this method compared to corporations from other countries, as many other country – e.g. all the EU countries – levy corporate tax on firm even without repatriation. Using this method, US firms can reinvest such money in their operation, which would have been paid in as tax if they would have had their seat outside
the US. With respect to the above, Treasury Secretary Jack Lew said, that “We recognize that the U.S. system will only tax this income upon repatriation, and many U.S. firms are choosing to defer paying tax liabilities by keeping income overseas in low-tax jurisdictions. This problem, however, does not give member states the legal right to tax this income. Doing so would directly harm U.S. taxpayers” (Lew, 2016).

Because of the several American firms involved - Starbucks, Amazon, Apple and McDonald’s fall all within the scope - American politicians are already opposed to the investigations. Their point of view is, that the Commission “appears to be disproportionately targeting U.S. companies” and “is in effect telling member states how they should have applied their own tax laws over a ten-year period” (Stack, 2015). A sign of how serious the pressure from the American side could be is that the Senate Finance Committee sent a so called bi-partisan letter to the Treasury in which even the application of IRC Section 891 was proposed as an answer for the retroactive state aid penalties that impact US MNEs. According to that Section, “Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax … shall … be doubled in the case of each citizen and corporation of such foreign country…”. Even if the application of such serious measures is not really expected, but these are great signs of the political pressure the EU faces these days.(Kluwertaxblog, 2016)

4. Conclusion

Profit shifting and tax avoidance became really important topics for numerous countries. Maybe due to the several different states trying to protect their own interest and supervising each other, the European Union is in particular active in these areas. As the implementation of the ideas came up cannot be forced into the tax system of the autonomous states, it will probably take long time and many political debates yet. In this political environment, the European Commission tries to step up against harmful tax practices in the EU with tools it already has. As a part of it, the application of Article 107 and 108 TFEU seems to be a promising way not to allow the use of such tax measures for
member states, which measures would grant advantage for undertakings in a selective manner.

State aid procedure is not new for the Commission and the CJEU, but its application by some of the tax rulings may be not grounded enough. Tax selectivity criteria of the Article 107 TFEU may be hard to prove. The Commission has two approach in this question: to determine the reference tax system, from which the investigated method differs or to find another undertaking in similar situation which has been treated differently. In the Starbucks case, the Commission tried to apply almost only the first approach during which it referred to the OECD Guidelines as reference system. However, considering that these Guidelines are just recommendations and their application is not binding for the Dutch tax authority, the legal ground of the use of Article 107 TFEU is questionable.

The tax ruling investigations of the Commission showed that some of the EU countries – e.g. The Netherlands, Ireland or Luxembourg - tried to be more attractive for foreign investors through ensuring them pretty good taxation conditions through tax rulings. These countries are expected to oppose these investigations. Moreover, as corporations from the United States have economic advantage compared to firms from other countries due to the differences between the U.S. and – for example – European taxation system and many U.S. firms are involved in the investigations, the Commission and the CJEU face immense political pressure from the U.S. The U.S point of view is, that the Commission has no right to tell member states how they should have applied their own tax laws, and mostly not retrospectively.

The outcome of the Starbucks case is hard to predict, but three option looks possible:

The first option is, that the Commission’s decision will be fully accepted by CJEU and Starbucks has to pay around €20-€30 million due to its unpaid taxes. The decision in Starbucks case can be referred to in other tax ruling cases, which will probably be a lot due to the automatic information exchange. If this scenario is followed, EU countries which tried to attract money due to their generous taxation system and loose understanding of international standards face serious problem. They have to decide then, whether they accept the loss of those benefits (money, job, etc.) they got due the followed method or – what I personally think would happen – they start to seek new ways to keep these benefits. However, that latter will be even harder as other tax avoidance measures (e.g. BEPS) will be implemented.
But this decision would trigger another changes too. The Unites States is not expected to use such tough measures as the application of IRC Section 891, but their company’s interest would be heavily breached thus they will surely change the taxation method they use, which may be disadvantageous for Europe. It may also happen, that these companies concerned will easily replace their operations into other, non-European low tax jurisdictions. In that case, the positive effects of the investigations may be exceeded by its disadvantages.

The second option is, that the Commission’s decision will be partly accepted, without the retrospective manner. Starbucks don’t has to pay but the followed taxation method shall be changed. The effects of that case would be almost the same as in the first option, as not the penalty itself what really concerns parties but the long-term change in the European taxation.

The third option is, that the Commission’s decision will be rejected and nothing has to be changed. That would surely give time for companies and states, however it’s questionable that how much. If it’s not the cross-border tax ruling investigation of the Commission what obstruct harmful tax-practices it can be one of the other measures initiated (BEPS, CCTB, etc.). In this respect, the question will only be politics: how important is that question for them, how they asses its advantages and disadvantages and how can they cooperate (which seems not to be their strength these days).

Independently which one of the above ways will be the final one, international taxation is expected to change a lot during next years. The Commission’s investigation could be a good way to make taxation more equal, but it seems not to be well grounded enough and the political pressure from the U.S. side is huge. Personally I think that the Commission’s decision will be fully rejected. I see it more possible, that these harmful tax practices will be terminated with the implementation of the other measures (BEPS, CCTB, etc.), however due to the political stress we see these days it will take a long time. Maybe if some of the states would really start to create an additional, stronger union, something like a United States of Europe as it is proposed by France and Germany, that would bring the real change in this area.
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