Vaasan yliopisto
UNIVERSITY OF VAASA

Alina Doumbouya z109225

State Aid and Transfer Pricing: The Different Perspectives of the European Commission and Multinational Entities

School of Accounting and Finance
Master's Thesis
Master's Degree Programme in
Accounting and Finance

Vaasa 2021

University of Vaasa
School of Accounting and Finance
Author: Alina Doumbouya z109225
Topic of the Thesis: State Aid and Transfer Pricing: The Different Perspectives of the European Commission and Multinational Entities
Degree: Master of Science in Accounting and Finance
Master's Programme: Accounting and Auditing
Supervisor: Marko Järvenpää
Graduation Year: 2021 **Pages:** 77

ABSTRACT:

Transfer pricing has become an integral part of the strategies of multinational entities due to the increasing volume of intercompany transactions. MNEs have recognized transfer pricing as an effective tool for allocating profits and as advantageous from a taxation perspective. In recent years, the European Commission has been more aggressive in reviewing the transfer pricing arrangements of multinational entities operating within the Union in order to curb agreements that unlawfully levy the tax liability of those entities. The purpose of this thesis is to examine how the Commission regards the legislation surrounding transfer pricing and compare that to the perspective of the MNEs.

This thesis studies transfer pricing from a legal point of view. Concepts like comparability and the arm's length principle that form the basis for transfer pricing are explained and examined. The relevant transfer pricing methods are presented with the purpose of providing understanding for the choices made by the MNEs and the Commission. EU law, specifically State aid rules, are described and clarified.

The empirical research was conducted through analysing two EU General Court cases involving Starbucks and Fiat. The notable differences in perspective between the Commission and the MNEs concerned, among other things, the definition of selective aid, the content of the arm's length principle and disguised tax harmonization. The key finding was that the fundamental difference in perspective was whether or not the Commission was entitled, under Article 107 TFEU, to question the tax rulings of national authorities.

KEYWORDS: siirtohinnoittelu, valtiontuki, markkinaehtoperiaate, peitelty verotuksen yhdenmukaistaminen, valikoiva tuki

VAASAN YLIOPISTO
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Tekijä:	Alina Doumbouya z109225
Tutkielman nimi:	State Aid and Transfer Pricing: The Different Perspectives of the European Commission and Multinational Entities
Tutkinto:	Kauppatieteiden maisteri
Oppiaine:	Laskentatoimen ja tilintarkastuksen maisteriohjelma
Työn ohjaaja:	Marko Järvenpää
Valmistumisvuosi:	2021 **Sivumäärä:** 77

TIIVISTELMÄ:

Siirtohinnoittelusta on tullut olennainen osa monikansallisten yritysten strategiaa lisääntyvien sisäisten liiketapahtumien johdosta. Siirtohinnoittelun on tunnistettu olevan tehokas keino voittojen jakamiselle ja verotuksen suunnittelun tuomien etujen hyödyntämiselle. Viime vuosina Euroopan komissio on tutkinut Euroopan unionin alueella toimivien monikansallisten yritysten siirtohinnoittelujärjestelyitä aggressiivisemmin. Tarkoituksena on ollut estää sopimuksia, jotka lainvastaisesti pienentävät monikansallisten yritysten verotaakkaa. Tämän tutkielman tavoitteena on verrata Euroopan komission ja monikansallisten yritysten näkemyksiä siirtohinnoittelulainsäädännöstä.

Tässä tutkielmassa siirtohinnoittelua tarkastellaan oikeudellisesta näkökulmasta. Siirtohinnoittelun perustan muodostavia konsepteja kuten vertailukelpoisuutta ja markkinaehtoperiaatetta käydään läpi ja niiden merkitys selitetään. Olennaiset siirtohinnoittelumenetelmät esitellään, jotta monikansallisten yritysten ja komission valintoja ja perusteluita on mahdollista ymmärtää. Euroopan unionin lainsäädäntöä, erityisesti valtiontukeen liittyviä säännöksiä, selkeytetään ja tarkastellaan tutkielmassa.

Tutkielman empiirinen osa toteutettiin analysoimalla kahta Euroopan yleisen tuomioistuimen tapausta, joiden kohteena olivat Starbucks ja Fiat. Suurimmat näkemyserot komission ja monikansallisten yritysten välillä liittyivät muun muassa valikoivan tuen määrittelyyn, markkinaehtoperiaatteen sisältöön ja peiteltyyn verotuksen yhdenmukaistamiseen. Tärkein havainto tutkielmassa oli, että perustavanlaatuisin näkemysero komission ja monikansallisten yritysten välillä liittyi siihen, oliko komissiolla oikeus, Artiklan 107 TFEU puitteissa, kyseenalaistaa kansallisten viranomaisten veroratkaisuja.

AVAINSANAT: siirtohinnoittelu, valtiontuki, markkinaehtoperiaate, peitelty verotuksen yhdenmukaistaminen, valikoiva tuki

Table of Contents

Figures

Abbreviations

AL	Arm's Length
APA	Advanced Pricing Agreement
CJEU	Court of Justice of the European Union
CP	Cost-Plus Method
CPM	Comparable Profit Margin Method
CUP	Comparable Uncontrolled Price
EU	European Union
JTPF	EU Joint Transfer Pricing Forum
MAP	Mutual Agreement Procedure
MNE	Multinational Entity
OECD	Organization for Economic Co-operation and Development
PSM	Profit Split Method
RPM	Resale Price Method
TFEU	The Treaty on the Functioning of The European Union
TNMM	Transactional Net Margin Method

1 Introduction

Multinational companies (MNEs) are operating in an unprecedently complex environment. The variety and rising volume of intercompany transactions and transfer pricing regulations have forced companies to define sustainable transfer pricing strategies. (Ernst & Young, 2010). MNEs use transfer pricing as a method to allocate profits among their subsidiaries as it offers many advantages from a taxation perspective (Choi et al., 2020). Effective but legal transfer pricing takes advantage of various tax regimes in different countries by shifting profits to countries with lower tax rates (Borkowski, 2008). There are risks involved in attempting to minimize taxation, such as increased taxation owing to tax audits and possible sanctions (Järvenpää et al., 2010).

Ever since Margrethe Vestager was appointed Commissioner for Competition in 2014 in the European Parliament election, the transfer pricing policies of major MNEs have been under intense scrutiny (European Commission, 2015). Vestager, who served as Commissioner for Competition from 2014 to 2019, was nicknamed “the world’s most famous regulator” or “the rich world’s most powerful trustbuster” after bringing lawsuits or fining companies like Google, Amazon, and Starbucks. EU competition law, and in particular State aid rules, have been used by the European Commission to challenge tax regimes and tax rulings given by some member states to certain MNEs (European Commission, 2015).

Transfer pricing is a method for pricing goods or services within and between group companies. In the last six years, the European Commission has taken a more aggressive approach to investigating and fining the transfer pricing practices of multinational companies operating in the EU in an effort to combat tax-driven business structures. A 2019 report by a special EU committee on financial crimes, tax evasion, and tax avoidance states that close to 40 % of MNEs’ profits are shifted to global tax-havens. According to the same report, tax avoidance through six EU member states results in a loss of 42,8 billion in tax revenue in the other 22 member states. (P8_TA(2019)0240)

The national tax legislation in most EU member states differs from EU legislation, and government officials and companies themselves interpret the different directives and Articles in a way that is different from the interpretation of the European Commission. This has led to many of the court cases having been taken to the EU's highest tribunal, the EU Court of Justice (CJEU).

1.1 Research question

The objective of this master's thesis is to examine how the European Commission interprets the laws surrounding the transfer pricing practices of multinational companies operating in EU Member States and contrast these views to the interpretations on the same laws by the MNEs operating in the EU.

The aim is to answer the following questions:

1. How has the European Commission intervened in the transfer pricing practices of multinational entities?
2. What is the basis for the way the transfer pricing decisions are made in the multinational entities?

1.2 Thesis structure

This thesis consists of seven main chapters. The first chapter introduces the topic, delimits the research, and defines the research question. The first chapter serves as an introduction to the whole master's thesis. It discusses why the European Commission has taken a more confrontational approach to the transfer pricing practices of MNEs.

In the second chapter, transfer pricing is defined, and the arm's length principle and comparability are explained. Comparability forms the foundation to transfer pricing, and by understanding comparability, it is possible to understand the difficulties with setting and arm's length transfer price. The second chapter also takes a look at the legislation surrounding transfer pricing. In order to understand and analyse the transfer pricing practices of MNEs, it is essential to know the regulation and guidelines around them. International tax law, EU law and national tax law are the primary sources of regulation for transfer pricing. In addition, the OECD transfer pricing guidelines will be examined in the second chapter because they have greatly influenced the transfer pricing legislation and practices of different countries.

Chapter three presents the five main transfer pricing methods, the traditional transaction methods and transactional profit methods, and explains how transfer prices are formed based on these methods. The selection of the appropriate transfer pricing method is critical for forming an arm's length price for a transaction.

The relevant EU Articles, regulation and guidelines are examined in the fourth chapter. State aid is given a closer examination as it forms the basis for the General Court cases discussed in chapter five. Understanding the scope of EU regulation is fundamental to understanding the arguments presented by the European Commission in the methodology part of this thesis.

Chapter 5 explains the research methods used in this study and presents the empirical research material. The research material consists of two EU General Court cases, Starbucks and Fiat, both of which are explained in detail.

Key findings are discussed and analysed in chapter six, and conclusions are drawn based on the two General Court cases. The research questions presented in the first chapter of this thesis are also answered.

In the concluding chapter, the whole thesis is briefly explained, and the purpose of the thesis is restated. Main findings are presented, and the limitations and reliability are discussed. Suggestions for further research are made.

2 Legislation and regulations regarding transfer pricing

2.1 Defining transfer pricing

Transfer pricing is a method for pricing goods or services within and between group companies. It is a crucial device for multinational enterprises (hereafter, MNEs) to maximize global profits. (Yao, 2013). Tax authorities claim that transfer pricing is stripping governments of their share of taxes and that MNEs are using transfer pricing policies "to shift profits from high-tax rate countries into low-tax rate countries." (Yao, 2013). According to a study by Horst (1971) in the absence of regulation, all profits would be shifted from high tax countries into low tax countries.

In international taxation, transfer prices are pricing principles where the income is accepted as taxable income in the country of the seller, and respectively, the expense is accepted as tax-deductible in the country of the buyer. This is how the group company defines how the income and expenses are divided between the different group entities. (Knuutinen, 2011) In a situation where the transfer price is not market-based, companies can suffer double taxation (Kukkonen & Walden, 2010) Double taxation refers to a situation where a taxpayer is subject to tax on the same income in more than one jurisdiction (Verohallinto, 2019).

Most countries have rules and regulations regarding transfer pricing in order to curb transfer price distortions and loss in tax revenues. The appropriateness of the transfer prices used by MNEs is often assessed using the arm's length principle (hereafter, AL). (Yao, 2013).

2.1.1 The arm's length principle

According to Yao (2013), "The AL principle is the principle associated with a transaction where the affiliates are dealing from an equal bargaining position, neither party is subject to the other's control or dominant influence, and the transaction is treated with fairness and legality." In effect, the AL principle is doing business without the purpose of artificially affecting the price. National tax authorities will correct the transfer price if it is believed to be notably different from the AL price (Yao, 2013). At its most basic level, the AL principle means that the price charged in a transaction between two related parties should be the same as the price charged in a comparable transaction between two unrelated parties.

According to Kukkonen & Walden (2010), the arm's length principle is a broad concept because comparability is affected by multiple different factors. When determining whether a transaction is carried out at arm's length, e.g., the quality and nature of the product or service being traded must be taken into account. When evaluating whether a transaction was carried out at arm's length, the functions performed by the parties should also be looked at. Among other things, planning, production, research and development, maintenance, finance, management, consulting and administration are considered functions. The broader and more demanding the functions performed by the party are, the bigger the compensation the party is entitled to is. This is called a functional analysis.

The evaluation of the arm's length principle is not solely based on price but also on the transaction terms. Terms in this instance mean any adjustments, discounts, terms of delivery and payments and risks of damage associated with the transaction. (Kukkonen & Walden 2010,) The fact that terms of an agreement are included in the AL principle is further proof of how comprehensive the concept is. For example, a product or a service may not be over-or under-priced, but some other part of the contract makes it a non-arm's length transaction.

2.1.2 Comparability

Rossing et al. (2017) state that comparability is the foundation of transfer pricing. The arm's length principle builds on the comparability between a transaction between independent parties and a transaction controlled by two parties belonging to the same group. In essence, comparability aims to determine whether the transfer price between related entities was carried out at arm's length and whether it can be substantiated by comparing that transfer price to a price between unrelated companies. The entities, as well as the transactions, have to be sufficiently similar to qualify as comparable. All transactions in the modern world are somewhat unique, so the comparability analysis is conducted case by case. (Kukkonen & Walden 2010)

Comparability can be demonstrated with either an internal or an external comparable. A party within an intragroup transaction is considered an internal comparable. (Raunio et al., 2018). A transaction between two independent parties is considered an external comparable. When a comparability analysis is made with external comparables, the first criterion is independence. Once the first criterion is met, other criteria such as financial conditions affecting comparability are examined. Thus, an external comparable cannot be a company whose business activities differ substantially from the transfer pricing transaction in question. (OECD, 2010)

Public databases are available for finding external comparables. In general, these databases provide income statements and balance sheets of publicly traded companies and the financial statements are usually consolidated. There are only a few universally accepted databases, Amadeus, in Europe, for example. Industry statistics are not considered comparable because statistics usually depict arithmetic mean and, thus, do not consider the unique features of different companies and transactions. Abandoning an external comparable should always be based on it not meeting the standard criteria set for comparability. (Kukkonen & Walden, 2010)

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) declare that choosing an external comparable should not be based on it having a similar line of business or similar products or services but on the conditions the company operates under being similar. For example, a big multimillion enterprise cannot be compared to a small company operating in the same industry. It is vital to be able to document and justify the chosen or abandoned comparables.

Internal comparables can be better as they are usually closer in similarity to the transaction than external comparables. Performing a financial analysis may be easier and is more reliable as the standards, e.g., for reporting, are similar, and more information is available. However, internal comparables still need to satisfy the five comparability factors. In a situation where a service or a product is sold to an intragroup company, and an external supplier, the similarity in the product or service and the volume sold need to be taken in to account. In the event of significant differences, the transaction with the external supplier is not a reliable comparable. (OECD, 2017)

When defining a transfer price according to the arm's length principle, the transfer pricing method applied should also be comparable. A comparability analysis is a comparison of a controlled transaction with an uncontrolled transaction or transactions. There is a nine-step process in the OECD transfer pricing guidelines for performing a comparability analysis used to test the AL principle. (Raunio et al., 2018). The OECD process is considered appropriate but other processes for a comparability analysis are also accepted. The outcome of the process is more important than the process itself. (OECD, 2017)

OECD (2017) nine-step process of comparability analysis:

Step 1:	Determination of years to be covered
Step 2:	Broad-based analysis of the taxpayer's circumstances
Step 3:	Understanding the controlled transaction under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account

Step 4: Review of existing internal comparable, if any

Step 5: Determination of available sources of information on external comparable where such external comparable are needed taking into account their relative reliability.

Step 6: Selection of the most appropriate transfer pricing method and depending on the method, determination of the relevant financial indicator

Step 7: Identification of potential comparable determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in step 3 and in accordance with the comparability factors set forth in Section D.1 of Chapter I

Step 8: Determination of and making comparability adjustments where appropriate

Step 9: Interpretation and use of data collected, determination of the arm's length remuneration

Although the abovementioned process is depicted as a step-by-step process, in reality, the process is not linear. Steps five and seven are often repeated to reach a satisfactory conclusion. The information available may affect the choice of a transfer pricing method, and in the case of lack of information, another transfer pricing method must be chosen. (OECD, 2017)

2.1.3 Disguised international transfer of profit

Disguised international transfer of profit happens when related entities do business with prices that non-related entities would not use. That is done through overpricing or under-pricing. With over-or under-pricing, related companies are shifting assets from one tax territory to another in order to gain a tax benefit. In the case of overpricing, company A sells products to company B for a price that is not marked-based. In the case example, company A charges an excessively high price with which a non-related company would not buy. The sole purpose is to transfer assets from company B to company A because company A operates in a tax territory with lower taxation. (Kukkonen & Walden, 2010)

In the case of under-pricing, company A sells products to company B for an excessively low price that cannot be considered marked based as company A would not sell the products to a non-related company for the same price. In such a case, company B operates in a tax territory with lower taxation. If we look at the companies selling underpriced or buying overpriced products individually, it may seem as though it is not financially profitable. However, in reality, when we consider the situation as a whole and see that the companies are related, it is a win-win situation for both companies.

When examining the legality of the transfer pricing practices of related companies, the true nature of the business transaction is under scrutiny. The basis for the examination is to answer whether the transaction would be the same if the companies would not be related. Transfer pricing is thus examined by evaluating how companies would act if they acted “naturally”. A relation between entities can lead to artificial decision-making to avoid taxes. (Kukkonen & Walden, 2010)

2.2 Tax conventions

Tax treaties are bilateral agreements between two countries. The purpose of tax treaties is to remove double taxation. The treaties consist of agreements upon how the right to tax concerning various categories of income are divided between the source country of income and the residence country of the beneficiary. (Verohallinto, 2020)

Most tax treaties follow the OECD Model Tax Convention (Verohallinto, 2020). The OECD Model Tax Convention includes multiple articles linked to transfer pricing, but the essential ones are article 7 (business profits), 9 (associated enterprises), and 25 (mutual agreement procedure). Additionally, articles covering interests, royalties and permanent establishments can be linked to transfer pricing.

2.2.1 Article 7 of the OECD Model Tax Convention

Article 7, Business profits, of the OECD Model Tax Convention (2017) states as follows:

> *1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.*
>
> *2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.*
>
> *3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.*
>
> *4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.*

The purpose of the Article is to explain the circumstances in which the business profits of a company may be taxed in a country other than the company's state of residence. If a company holds a permanent establishment in a country other than its state of residence, that country also has the right to tax income and profit after expenditure. That leads to double taxation, which the Article aims to eliminate. If, however, a company operates but does not hold a permanent establishment in another country, the profits are only taxed in its state of residence. (Feinschreiber & Kent, 2012)

Arbitration agreements between different countries determine how the taxable income of enterprises is distributed between the contracting states. An arbitration agreement is only applied on income taxes and can be agreed upon even if the taxation in one contracting state is higher than in the other. (Helminen, 2018) The AL principle is applied when determining the income distribution at the state of the permanent establishment.

According to the OECD Model Tax Convention, a two-step approach to revenue allocation should be followed. First, a functional analysis is done to assess the transactions and risks between the affiliated companies. Secondly, the transactions between the affiliated companies are priced according to the arm's length principle defined in the OECD Transfer pricing guidelines for multinational enterprises and tax administrations. (Malmgren & Myrsky, 2017)

2.2.2 Article 9 of the OECD Model Tax Convention

Article 9, Associated enterprises, of the OECD Model Tax Convention (2017) states as follows:

> *1. Where*
>
> *a) an enterprise of a Contracting State participates directly or indirectly in the* management, control or capital of an enterprise of the other Contracting State, or
>
> *b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two 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.*

> *2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.*

The Article, as mentioned above, has its basis in the arm's length principle. In effect, it means that the transactions between related companies should be organized as they would be between unrelated companies. Article 9 is only applicable when the affiliated companies do not follow the arm's length principle. (Raunio & Karjalainen, 2018) The usual interpretation for Article 9 is that it does not prohibit national legislation from requiring more in-depth reporting, i.e., transfer pricing documentation requirements. Similarly, the Article does not prohibit laying the burden of proof on the taxpayer in matters related to transfer pricing. (Raunio & Karjalainen, 2018)

Paragraph 2 of the Article states that a counter-adjustment can be made if the tax authorities of a contracting country have, according to the provisions in the first paragraph, adjusted the amount of taxable income. The aim is to prevent double taxation of the same income in two different companies, both of which comprise one economic unity. (Raunio & Karjalainen, 2018)

2.2.3 Article 25 of the OECD Model Tax Convention

Article 25, Mutual agreement procedure, of the OECD Model Tax Convention (2017) states as follows:

> *1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with*

the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of either Contracting State. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

5. Where,

a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities, any unresolved issues arising from the case shall be submitted to arbitration if the person so requests in writing. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting

> *States shall by mutual agreement settle the mode of application of this paragraph.*

The purpose of Article 25 is to allow Member States to use the Mutual Agreement Procedure (MAP) to decrease the chances of double taxation. The MAP can be used in situations such as conflicts of interpretation of tax treaties between the Member States, income allocation to a permanent establishment, compliance with the AL principle and in deciding whether a permanent establishment exists in a state. The procedure is designed to help the authorities of different states to prevent double taxation. Regardless of whether an agreement is an individual matter or a more comprehensive agreement, Article 25 permits reciprocal dialogue between Member States' tax authorities on issues regarding transfer pricing. The MAP is essentially a framework for how the Member States cooperate when problems arise. (Verohallinto, 2021)

If necessary, a person may rely on Article 25 in order to prevent double taxation. That means that the application of the article is also proactive and can be used as a pre-contractual procedure for a preliminary ruling. If a taxpayer has already been subjected to tax in more than one member state, the mutual agreement procedure can also be initiated under the EU Arbitration agreement. (Jaakkola et al., 2012). The procedure is parallel to a national appeal. If the taxpayer does not regard the decision of her/his national tax authority satisfactory, she/he may require the initiation of the contract procedure. However, the mutual agreement procedure does not require tax authorities of different member states to reach an agreement which may be dissatisfying for the taxpayer. (Raunio & Karjalainen, 2018)

3 Transfer pricing methods

Transfer pricing methods are used to test or calculate the arm's length nature of prices. The methods are ways of creating arm's length prices from transactions between associated enterprises. "Controlled transaction" is the transaction between associated enterprises for which an arm's length price is established. The utilization of transfer pricing methods helps ensure that transactions follow the arm's length standard. (Department of Economic and Social Affairs, 2013)

A transfer pricing method should be selected based on what is most appropriate for a particular case. The selection process can include determining: the nature of the controlled transaction, the strengths and weaknesses of each method, the availability of reliable information, and the degree of comparability between the controlled and uncontrolled transactions. (Department of Economic and Social Affairs, 2013)

The methods fall into two categories, traditional transaction methods and transactional profit methods. The traditional transaction methods are comparable uncontrolled price method (CUP), resale price method (RPM) and cost-plus method (CPL). The profit split method and the transactional net margin method are transactional profit methods. (Kukkonen & Walden, 2010) While the transactional profit methods examine a company's profits as a whole, traditional transaction methods examine individual transactions.

There are also other methods in addition to these five main transfer pricing methods, but those are not gone through in detail due to the scope of this thesis. In general, none of the methods is considered "a universally accepted method" so that it could be chosen for all situations.

Rejecting a single method is not considered to follow the arm's length principle. According to the arm's length principle, any method can be chosen if enough information of transactions between unrelated companies is produced in comparable circumstances compared to the transactions between associated companies. Choosing the best method is based on evidence, which is the quality and quantity of comparable information and how they suit the chosen method. (Kukkonen & Walden, 2010)

Kukkonen & Walden (2010) state that different countries have differing hierarchies concerning the use of transfer pricing methods. In principle, the comparable uncontrolled price method is treated as the most reliable method in terms of the result. The method is accepted in various countries, and problems concerning interpretation of the use of the method are considered to be the smallest.

The need to use methods other than the CUP is highlighted in cases where the transfer pricing is open to interpretation. Using alternative methods is also accepted when they are perceived to be more suitable for determining an arm's length price. That is often the case when there is a lack of reliable information. (Kukkonen & Walden, 2010) In some cases, it is necessary to use multiple transfer pricing methods at the same time. However, the prerequisite for this is that the results of the different methods used are roughly the same. Different methods inevitably produce different prices, but they also establish a range for evaluating an acceptable transfer price. (Kukkonen & Walden, 2010)

The resale price method is deemed more reliable than the cost-plus method. Generally, the traditional methods, CUP, RPM and CPL, are the most direct methods for assessing a transaction's arm's length price. Transactional profit methods are regarded as secondary methods as much uncertainty is related to applying the methods. The uncertainty mostly has to do with how much information is needed for applying a transactional profit method. However, the use of the methods is also more open to interpretation compared to the traditional transaction methods. That is why transactional profit methods are not widely used in many countries. It is, however, advisable to use the transactional profit methods alongside the traditional transaction methods rather than apply the transactional profit methods alone. That is done to find an acceptable range for the arm's length transfer price. Out of the two transactional profit methods, the transactional net margin method is more applicable than the profit split method. (Kukkonen & Walden, 2010)

Each method produces a result that more or less varies from the result of another method. If a price is within a range created by two different methods, it can generally be deemed to be arm's length or at least very close to being arm's length. Materiality should be taken into account when assessing the arm's length pricing. (Kukkonen & Walden, 2010)

3.1 Comparable uncontrolled price method, CUP

The comparable uncontrolled price method compares the price used for services or products transferred in a controlled transaction to the price used in an uncontrolled transaction in comparable circumstances. The comparable transactions in CUPs may be based on "internal" or "external" transactions.

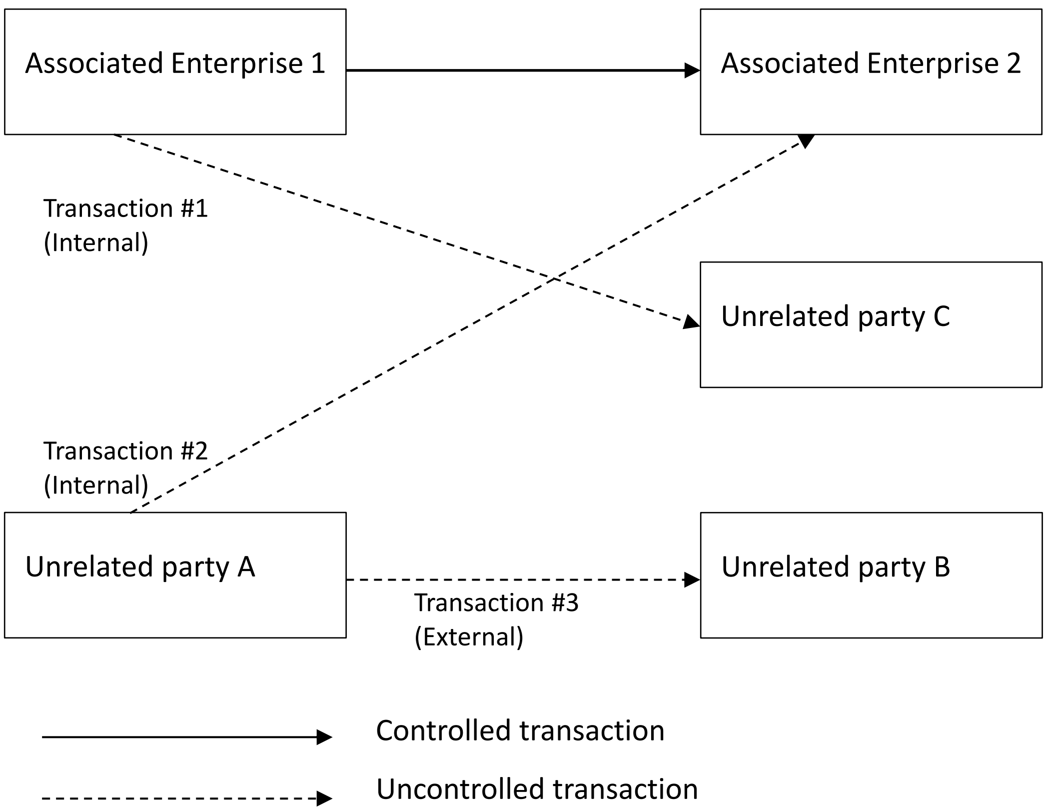

Figure 1. Comparable uncontrolled price method (Department of Economic and Social Affairs 2013)

Basing the CUP method on an internal transaction means that a company uses comparable transactions it has made with third parties as the basis for the arm's length transfer price. When using external transactions as the basis for the arm's length transfer price, a company may look to the pricing of comparable transactions between third parties. Multiple transactions between unrelated parties can be compared in CUP. The results of these comparisons set the limits within which associated parties may carry out transfer pricing. (OECD, 2010)

The CUP method is a market-based method, so it is considered the primary method for determining a transfer price. It is very reliable if there are enough comparable transactions available. Thus, the method should be used whenever possible. A justification has to be given if the CUP method is not used in determining a transfer price. The CUP method is also the only transfer pricing method accepted in all states. (Kukkonen & Walden, 2010)

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017) state that an unrelated transaction is comparable if one of the following conditions is true:

1. The price in an open market cannot be substantially affected by any difference between comparable transactions or any difference between companies involved in the transaction or

2. Reasonable adjustments can be made to remove the effects of such substantial differences.

The CUP method is relatively easy to use with products or services, of which a great deal of market data is available. Then what is left is to determine the unique characteristics of the business that affect comparability. E.g., delivery method, volume and contractual terms are unique characteristics. Unfortunately, it is often challenging to find external transactions that are sufficiently comparable.

The comparable uncontrolled price method is most suitable for products with few unique characteristics such as raw materials, real estate and even publicly traded securities. Services and intellectual property rights are generally unique, so it may be difficult to assess their comparability. (Department of Economic & Social Affairs, 2013)

3.2 Resale price method (RPM)

The resale price method (RPM) is another traditional transaction method. However, unlike some other methods that can be used to analyse more than one type of intercompany transaction, the resale price method is always applied to tangible property transactions. As a starting point, the RPM takes the price at which a related party sells a service or a product to a third party. This price is known as the ”resale price”. After that, the resale price is reduced by a gross margin and other costs related to the service or product. The gross margin, together with the other costs, is called the resale price margin. The resale price margin is determined by comparing gross margins in comparable uncontrolled transactions. Gross margin is determined by the expenses incurred by the operations of the reseller and a profit margin that takes into account the assets of the reseller and the risk of the operations conducted by the reseller (gross profit divided by net sales). The resulting gross margin, usually expressed as a percentage, is then used to determine the appropriate gross margin that a controlled entity should earn. (Department of Economic & Social Affairs, 2013)

The application of the resale price method looks to transactions between unrelated parties as a means to determine an arm’s length resale price. That is because prices between unrelated parties are the result of natural and market-based negotiations. (Department of Economic & Social Affairs, 2013)

Let us say company A, which is related to company B, sells products to the company as mentioned above. Company B then resells the products to Company C, which is not related to either company A or B. The price with which company B sells the products to company C is the resale price. Once the expenses of company B, which are related to the products and a reasonable profit margin, are deducted from the resale price, we are left with a price that can be used in determining transfer prices. (Kukkonen & Walden, 2010)

The OECD transfer pricing guidelines for multinational enterprises and tax administrations (2017) have the same rules concerning the resale price method as the previously talked about comparable uncontrolled price method: the price in an open market cannot be substantially affected by any difference between comparable transactions or any difference between companies involved in the transaction, or reasonable adjustments can be made to remove the effects of such substantial differences.

The appropriate gross margin in the resale price method can be determined by counting the company's gross margins from transactions between unrelated companies. It is also possible to evaluate the gross margins earned by unrelated third-party distributors of similar products and benchmark an appropriate gross margin against those. (Kukkonen & Walden, 2010)

When evaluating an appropriate gross margin, the circumstances surrounding the transaction must be taken into account in the resale price method. For example, the risks related to the operations of the reseller would affect the appropriateness of a gross margin used in the RPM. The risk increases for the reseller the longer it has to hold on to the products it has purchased, and this should be factored in when counting a gross margin. (Department of Economic & Social Affairs, 2013)

In general, the typical gross margin of an industry can be accepted as the appropriate gross margin in the RPM. However, a higher gross margin can be justified by the reseller having unique expertise or by the reseller having shown efficacy, which in turn would lead to earning a higher gross margin than other companies. (Kukkonen & Walden, 2010)

The resale price method can be very effective for ensuring that intercompany transactions are carried out at arm's length. Comparability requirements for the resale price method are slightly less stringent than with some other methods because the gross margin is utilized to determine the price. There can thus be minor differences in the underlying product features when applying the method. Gross margins can vary dramatically between different products, say running shoes vs computer hardware, but between, say, different colours/designs of running shoes, the gross margin will be relatively comparable. (Department of Economic & Social Affairs, 2013)

While the resale price method can be beneficial under the right circumstances, it is not very commonly applied. That is because it still requires the existence of comparable controlled and uncontrolled transactions, despite allowing for slightly more variables than some other methods. Available gross margin data on a transaction-by-transactions basis is also required.

3.3 Cost-plus method (CPL)

The Cost-Plus Method is also a traditional transaction method that compares gross profits to the cost of sales. Under the Cost-Plus Method, the first step is to determine the manufacturing costs incurred by the supplier in a controlled transaction. Next, a marked-based mark-up is added to this cost to get a reasonable profit considering the functions performed. To ensure the transfer price follows the AL principle, mark-ups realised in comparable transactions between unrelated entities are compared against the mark-up added to the incurred manufacturing costs. (Kukkonen & Walden, 2010)

In the CPL, costs that can be directly linked to the product must be taken into account. On top of that, an estimation of indirect costs of production must also be included as well as a part of all other costs of the whole company. In this instance, indirect costs are the same as variable costs that are directly proportional to the number of produced products. For example, raw material and salaries related to the production of products are considered direct costs. Indirect costs are costs incurred by multiple activities, e.g., rents. (Kukkonen & Walden, 2010)

The third cost type is fixed overhead which includes, e.g., administration and supervision costs. Indirect costs are allocated to products, services and intangible rights, and the allocation is based on cost accounting, profitability calculation and accounting information. The allocation can be done by utilising either job costing or process costing. (Kukkonen & Walden, 2010)

The Cost-Plus method works best with manufacturing companies that contract exclusively with one client. It is especially good for assessing the transfer prices between different manufacturing and subcontracting chain companies. Suppose a company sells similar products with similar terms to both related and unrelated companies. In that case, the acceptable mark-up added to the costs will be based on the price used between unrelated companies. If a company does not sell to unrelated companies, the acceptable mark-up will be determined by analysing the cost structures of unrelated companies. That is considered extremely difficult in practice because information on cost structures is scarcely available in public databases. That is because companies are not obligated to release information on product-based operating profit. However, suppose the business activities of a company are relatively simple (say, a company that only manufactures iPhone cases). In that case, it is possible to figure out the operating profit from the income statement, which can be found on the financial statements that a company has to make public. (Department of Economic & Social Affairs, 2013)

As with the other transfer pricing methods, the big picture is essential in the CPL as well. An acceptable margin between related companies is fundamentally the same margin as with unrelated companies when dealing with similar products and terms. (Kukkonen &

Walden, 2010). The downside is that it requires for the controlled and uncontrolled transactions to be highly comparable. Detailed information on cost structures and products is needed to establish a high level of comparability. If the information is not available, the Cost-Plus Method cannot be used.

3.4 Transactional net margin method (TNMM)

The transactional net margin method is one of the secondary transfer pricing methods and a "Transactional profit method" along with the Profit split method (Department of Economic & Social Affairs, 2017). Contrary to traditional transfer pricing methods, the analysis is not automatically based on transactions with largely comparable or identical products in the transactional profit methods. Depending on the conditions, the analysis is based on the realized net return by different companies in a distinct line of business. Companies rarely use transactional profit methods to determine a price. However, the profit from a controlled transaction may be a good signal to determine whether a transaction was influenced by conditions that would not have been made between independent enterprises. (Department of Economic & Social Affairs, 2013)

The Transactional Net Margin Method compares the net operating profit realized from controlled transactions. After that, a comparison is made between that profit level and the profit level realized by independent entities involved in comparable transactions. (Department of Economic & Social Affairs, 2013) The profit level indicator is the most critical aspect of the Transactional Net Margin Method. It is a ratio of net profit relative to an appropriate base. Sales, costs, salaries or assets are used as a base. The profit level indicator is then used by comparing it to the net profit earned in a comparable uncontrolled transaction. (Kukkonen & Walden, 2010) The TNMM is often used on services, intangible property or tangible property (Department of Economic & Social Affairs, 2013).

Figure 2 below illustrates the use of the profit level indicator. Company X represents an independent undertaking and Company Y an affiliated undertaking. The profit level indicators of Company X are compared to those of Company Y to determine the legality of Company Y's transfer pricing. Seeing as the profit level indicators of Company X and Company Y differ, the latter's pricing is not concordant with the AL principle in the TNMM.

	Company X	Company Y
Operating profit/turnover ratio	0,4	0,1
Operating profit/personnel costs ratio	3	-1
Operating profit/assets ratio	2	-1

Figure 2. TNMM & the profit level indicator

3.5 Profit split method (PSM)

If associated companies engage in interrelated transactions, they cannot be examined on an individual basis. In these situations, associated companies usually agree to split the profits. The Profit Split Method considers the terms and conditions of these types of controlled transactions. It seeks to eliminate the effect on profits by establishing the division of profits that independent companies would have made from the same transactions. (Department of Economic & Social Affairs, 2013)

The PSM begins by determining the total profit for the transactions between associated companies. Then the profits are divided between the companies on the basis of the relative value of each company's contribution. The contribution should take into account the risks incurred, the functions performed, and the assets used by each company in the transactions. If possible, external market data should be used to value each company's contribution to ensure the valuations compare to those of independent companies. (JTPF/002/2019/EN)

There are two different Profit Split Methods:

1. Contribution profit split method
2. Residual profit split method

The combined profits are allocated between the companies based on the relative value of the functions performed and the risks assumed under the contribution analysis. Usually, the combined profits should be calculated on the basis of operating profits. However, in some cases, gross profits are divided first, and then the costs attributable to each company are subtracted. (Department of Economic & Social Affairs, 2013)

A two-step approach is used to allocate combined profits between associated companies under the residual analysis:

Step 1: identifying the routine profit for a company. The profit is determined based on the profit earned by comparable independent companies.

Step 2: Allocating the remaining profit based on the contribution of each party to the earning of the non-routine profit e.g., intangible property.

Typically, the residual analysis is used in cases where both transaction parties contribute valuable intangible property. (Department of Economic & Social Affairs, 2013)

4 EU regulation and other acts

The European Union has strived to make transfer pricing regulation uniform within the whole EU. Regardless, the EU guidelines concerning transfer pricing are not extensive. The EU transfer pricing regulation can be divided into two parts: the arbitration agreement (90/436/ETY) and the subsequent Arbitration Convention (European Commission 2021) and the instructions by the EU Joint Transfer Pricing Forum (JTPF).

The purpose of the arbitration agreement is to resolve disputes when double taxation occurs between member states. The arbitration agreement is not EU legislation per se as it is an agreement by EU member states on the elimination of double taxation in the case of associated enterprises' transfer of profit. However, it is binding for the member states. The Arbitration Convention improves the conditions for cross-border transactions by providing for the elimination of double taxation in the contracting Member States. (European Commission, 2021)

The function of the EU Joint Transfer Pricing Forum is to advise and assist the European Commission on transfer pricing issues. It also releases reports and instructions regarding transfer pricing. Unlike the arbitration agreement, the recommendations and guidelines of the JTPF are not binding even though the recommendations have been appealed to in tax practices.

EU directives and regulations set obligations for all its Member States. According to European Union (2020), "a regulation is a binding legislative act". That means that the regulation in its every respect must be applied in all EU countries. A directive "is a legislative act that sets out a goal that all EU countries must achieve", meaning the individual countries can decide what laws to prepare to reach that goal. (European Commissiom, 2020). To better understand the court cases discussed later, the relevant EU Articles will be examined in the following chapters.

4.1 State aid

Article 107 of the Treaty on the Functioning of the European Union states that “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.” De facto, this indicates that, e.g., tax agreements with national tax authorities are prohibited if they give an unfair advantage over the entity’s competitors. Exceptions can be made regarding aid having a social character or aid repairing damage caused by natural disasters or exceptional circumstances.

For something to be State aid, it needs to have the following features:

- An intervention has been made by the State or through the resources of the State. This can, for example, be tax reliefs, grants, better terms for goods and services, guarantees etc.
- The recipient is given an advantage on a selective basis because of the intervention e.g., to companies in specific regions or to distinct industry sectors or companies
- Competition has been or may be distorted
- Trade between Member States will likely be affected by the intervention

Even though State aid is generally prohibited, there are situations where government interventions are necessary. Thus, State aid can be considered compatible in some cases, and these exemptions are stipulated in the legislation. (European Commission, 2019)

State aid is controlled primarily to support fair competition. When a company receives support from a government, it inherently gains an advantage over its competitors. State aid measures can only be implemented after approval by the Commission. Furthermore, the Commission has the right to recover incompatible State aid. (European Commission, 2019)

Article 108 of the TFEU states that “The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the internal market.” EU member states are thus required to report all state aid given to different entities. If the Commission finds that the State aid given by a State or through State resources is not compatible with the internal market as stated in Article 107 of the TFEU, said State aid must either be abolished or altered to comply with Article 107. The abolition or alteration must be done within a time period set by the Commission. If, after the period given by the Commission, the State aid in question does not comply, the Commission or any other interested state may refer the case to the Court of Justice of the European Union (CJEU).

According to a survey by the European Commission (1997) high levels of State aid are regarded as a risk to the functioning of the internal market. State aid is also considered as a source for distorting competition within the European Union.

4.2 Other relevant articles

The following articles are briefly explained because of their importance in understanding the basis for the arguments presented in the General Court cases discussed in the Methodology part.

Article 114 TFEU is the most important legal basis for the harmonization of national legal provisions. According to the Article, the Union may adopt “measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.” In practice, this means that whenever there are disparate national rules, the EU is allowed to create legislation for the adoption of a single standard in EU member states, thus removing obstacles to trade in the internal market. That is often done through directives.

Article 296 TFEU states:

"Where the Treaties do not specify the type of act to be adopted, the institutions shall select it on a case-by-case basis, in compliance with the applicable procedures and with the principle of proportionality.

Legal acts shall state the reasons on which they are based and shall refer to any proposals, initiatives, recommendations, requests or opinions required by the Treaties.

When considering draft legislative acts, the European Parliament and the Council shall refrain from adopting acts not provided for by the relevant legislative procedure in the area in question."

In effect, the Article requires the Commission to give sufficient reasoning for administrative decisions taken, particularly in the context of competition.

Article 4 (2) of the Treaty on European Union (TEU) contains the national identity clause. It says “The Union shall respect the equality of Member States before the Treaties as well as their national identities, inherent in their fundamental structures, political and constitutional, inclusive of regional and local self-government. It shall respect their essential State functions, including ensuring the territorial integrity of the State, maintaining law and order and safeguarding national security. In particular, national security remains the sole responsibility of each Member State.” The national identity clause may prove significant as a justification for failing to fulfil obligations made by EU law as the ECJ is required to respect the national identity of all member states.

Article 5(2) TEU states that “Under the principle of conferral, the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences not conferred upon the Union in the Treaties remain with the Member States.” The Article also includes the principle of proportionality, giving the EU the right only to take the needed action and nothing more.

Both Articles 4 and 5 refer to the distribution of competencies, meaning that the EU can only act within the limits of competencies provided by the EU treaties. The European Union does not have any competencies by right, so everything outside of the treaties remain the domain of the member states.

The principle of legal certainty is “a general principle of EU law” that requires that the legal rules are clear and precise. The principle is focused on ensuring that in the cases where EU law is the governing law, situations remain foreseeable. (T-755/15, Fiat Chrysler Finance Europe vs. Commission, EU:T:2019:670)

5 Methodology

This chapter discusses the research methods used, case material acquired for the empirical research and the methods of analysis used on the material. The reliability, credibility and validity of the research are also considered.

Most prior transfer pricing research has mainly been focused on MNE behaviour and MNE issues with and reactions to transfer pricing regulation. In contrast, this master's thesis looks at the European Commission's concerns about transfer pricing, the existing regulation and its different interpretations and MNEs' methods of shifting profits to low-tax countries.

5.1 Research methods

The empirical research in this master's thesis was conducted as qualitative research. Qualitative research aims to form a comprehensive understanding of the research subject (Kananen, 2017). Qualitative research is usually not amenable to measuring or counting. In contrast, it is used to answer questions about perspective or experience. Qualitative research outcomes cannot be used as generalisations as with quantitative research, but the outcome should be applicable in similar circumstances. (Hammarberg et al. 2016) In qualitative research, observations are simplified, and the concentration is on the essential things. (Alasuutari, 2011) Qualitative research was chosen as the preferred method due to the nature of the thesis. The objective is to analyse and compare perspectives that cannot be done through quantitative research.

The chosen qualitative research method is a case study. According to Scapens (1990), a single unit is analysed in a case study. The aim is to understand the phenomenon selected for the study, and the focus is on the circumstances of a particular case. In this master's thesis, two different EU General Court cases are presented, analysed and compared to form an understanding of the different viewpoints of the European Commission and the MNEs. Despite the premise of empirical research in accounting and finance not being primarily juridical, it resembles the used method of a case law analysis.

5.2 Starbucks

Starbucks Corp. is a multinational café chain founded and headquartered in Seattle, United States, in 1971. Starbucks Manufacturing EMEA BV (referred to as SMBV) is a subsidiary of the Starbucks group, established in the Netherlands. Alki LP (referred to as Alki) is another subsidiary of the Starbucks group, established in the United Kingdom that directly controls SMBV. SMBV and Alki have settled in a roasting agreement that states that SMBV is obliged to pay Alki a royalty for the use of Alki's intellectual property rights. The intellectual property rights include roasting methods and other expertise related to roasting. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The corporate income tax system in the Netherlands states that companies established in the Netherlands must pay corporate income tax and are subject to the tax on their worldwide income. Additionally, companies that are not established in the Netherlands but have economic activity in the state must also pay corporate income tax but only on their income from Netherlands sources. According to the total profit concept, if the profits derived from economic or commercial activity, the profits must be taxed, and that concept is applied to all taxpayers. Article 8 of the CIT (law on corporation tax) states that "the taxable yearly profits must be determined on the principles of sound business practice and in a consistent manner independently of the likely outcome." Article 8b(1) of the CIT describes that if the transfer prices between related entities differ from those between independent entities, the profit of these entities should be taxed in the same way as the profits of the independent entities. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The AL principle is an essential element of the Netherlands system of tax law, and it is incorporated in Section 3.8 of the Income Tax Act. That means that the Transfer Pricing

Guidelines for Multinational Enterprises and Tax administrations apply directly to the Netherlands under that Act. The Netherlands has a 12-part decree explaining its position related to the AL principle, transfer pricing methods, secondary adjustments and determining the arm's length price in cases of high uncertainty, among others. According to the decree, traditional transactional methods are given preference over transactional profit methods. However, as long as the selected method results in conformity with the AL principle, the taxpayer is free to choose a method. The reliability of that method must be considered when choosing the method. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

SMBV agreed on an advance pricing agreement (referred to as the APA) with the tax authorities of the Kingdom of the Netherlands in April 2008. The objective was to resolve the remuneration for the production and distribution activities within the Starbucks group and its subsidiaries. SMBV's remuneration served to determine its taxable profit every year based on the Netherlands' corporate income tax. The APA is a tax agreement that is concordant with the arm's length principle commonly used in transfer pricing to determine profit within a multinational corporation with multiple international subsidiaries. It is evident from the APA that the agreement has been concluded for the purposes of the annual corporate income tax declarations in the Netherlands. The APA recommended the amount of royalty paid to Alki by SMBV for the use of its intellectual property, 'the roasting IP'. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

SMBV's functions were mainly to produce roasted coffee beans and provide those beans and other related products to Starbucks stores in Europe, Middle East and Africa (the EMEA region) according to the APA. It also owned a roasting complex in the Netherlands. In addition, it carried out a distributor function for other coffee-related products as well as provided support in logistics for other products on particular markets. Furthermore, SMBV was licensing certain IP rights that belonged to Alki and were necessary for processing, producing and providing coffee to the different stores. SMBV paid royalty to Alki to that end. Below is an illustration of the operations conducted by the different subsidiaries of Starbucks Corp.(T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

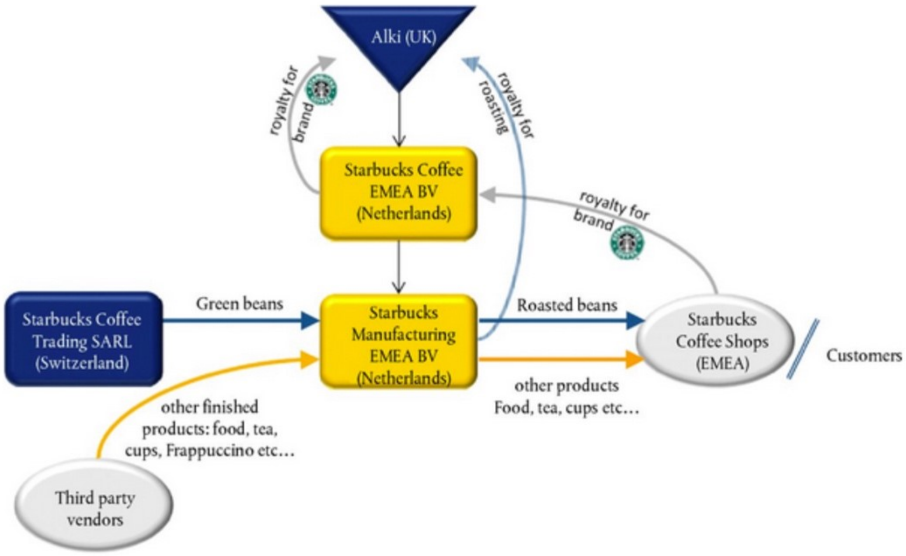

Figure 3. The Starbucks group operations (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The APA stated that SMBV's remuneration was to be determined on the basis of the cost-plus method and that it was in accordance with the arm's length principle if the operating margin reached a certain percentage of the relevant cost base. The cost base of SMBV did not include (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

- the costs of the Starbucks cups, paper napkins, etc.
- the costs of green coffee beans"
- the distribution and logistics cost relating to services provided by third parties and to the remuneration for activities provided by third parties under consignment manufacturing contracts
- the royalty payment

The royalty SMBV was paying to Alki annually was "fixed based on the difference between the operational profit made in respect of the production and distribution function, before royalty expenses and SMBV's remuneration". The royalty payment was not subject to withholding tax in the Netherlands and was deductible for corporate income tax purposes. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The dispute started in 2013 when the European Commission sent an initial request to the Netherlands for detailed information on its tax ruling. In June 2014, the Commission started a formal investigation regarding the APA, on the basis of that agreement being presumed to be State aid under Article 107(1) TFEU. In October 2015, the Commission declared that in its investigation, it had concluded that the APA constituted aid incompatible with the internal market and called for the returning of that aid. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

According to the transfer pricing report that was part of the APA, the Commission stated that TNMM was selected as the appropriate method because there were fewer errors "in the differences between transactions and the functions of entities to be compared to determine the net margin than in traditional methods". The profit level indicator chosen by Starbucks group's tax advisor was the operating costs for the activities where SMBV provided added value. After a comparability search, the tax advisor had also concluded that the net profit of comparable entities to SMBV corresponded to a mark-up on total costs. After that, two adjustments were made to take into account the differences between SMBV and the compared entities. The first of those adjustments was an adjustment to the cost base of SMBV, to which the mark-up was applied so that the fact that the cost base did not include the cost of green beans was taken into account. The second adjustment sought to consider that the comparable entities carried the cost of raw materials, which were also included in their cost base on which their return was calculated. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

According to the Commission, the first condition to the existence of State aid, an intervention by the State or through State resources, had been satisfied as the Netherlands' tax administration had accepted the APA. Therefore, it was imputable to the Kingdom of the Netherlands. As a result of the APA, SMBV's tax liability had been lowered from what it would, in the absence of the APA, have had to pay under the corporate income tax system of the Netherlands. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The second condition of the intervention having to be liable to affect trade between the Member States was met since Starbucks group is a global entity operating in all Member states and SMBV belongs to the corporate group. The fourth condition of distorting or threatening to distort competition was met as the APA reduced the tax burden of SMBV and thus strengthened its financial position. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

A three step-analysis was used to determine if the third condition, of whether the aid was selective, had been met. The identification of the reference system, the general Netherlands corporate income tax system in the case at hand, was the first step. In the Commission's view, if a tax measure results in reduced tax liability from what the entity would normally have to pay under the reference system, that reduction creates a derogation from the reference system as well as grants an advantage. The second step of demonstrating a derogation from the reference system had thus been accomplished. According to the Commission, the previous case law has established that the identification of an economic advantage granted by an individual measure is enough to support the supposition that the measure is selective. It stated that the APA granted to SMBV constituted an individual measure. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The Commission then elaborated several lines of reasoning to prove that the APA provided a selective advantage to SMBV. In its primary reasoning, the Commission stated that the choice of TNMM was erroneous and that the transfer pricing report had failed to inspect whether the intra-group transfer was in line with the arm's length principle. Furthermore, there was the failure to identify and analyse controlled and uncontrolled transactions, which, for assessing the arm's length nature of a transaction, is necessary. The Commission also stated that if the transfer pricing report had correctly examined the royalty with the CUP method, the arm's length value would have resulted in zero. No profits were generated to SMBV from the IP rights that were the subject of the royalty as long as it did not exploit them on the market. Hence, the Commission concluded that the profits paid to Alki should have been taxed in the Netherlands in full. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The Kingdom of the Netherlands and Starbucks raised arguments attempting to justify the amount of royalty, but the Commission rejected the arguments. In the Commission's view, Alki could not take over SMBV's entrepreneurial risks with the royalty payment. Otherwise, associated companies could reallocate risk contractually and escape conforming to the AL principle. Additionally, the size of the amounts paid by Alki to Starbucks US could not justify the royalty payment. The purchase price of green coffee beans had also not been inspected in the transfer pricing report, even though the report classified it as one of the significant transactions affected by SMBV. After evaluating the price of the green beans, the Commission determined that SMBV bore significantly higher costs than SCTC, and it was not an honest estimation of a market-based outcome. The Commission then concluded that there was a selective advantage since the price premium paid by SMBV lowered its profits and, therefore, taxable base. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

In the Commissions view, even if the TNMM were assumed appropriate for identifying the profits made by SMBV, the method had been incorrectly applied in the transfer pricing report. First, SMBV was identified as the least complex entity and for the purposes of applying TNMM as the tested party. According to the Commission, SMBV should have instead been regarded as the most complex entity since the functions Alki performed were limited, and the function of roasting performed by SMBV was an essential function instead of a routine one. On top of that, SMBV also performed other functions. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Second, operating costs used as a profit level indicator was inappropriate. According to the Commission, reselling and distribution was SMBV's principal function rather than roasting, as stated in the transfer pricing report. Therefore, the use of recorded sales would have been a more appropriate profit level indicator. That would have led to a higher level of remuneration for SMBV's activity. The Commission then calculated a profitability ratio for roasting and reselling activities and compared that ratio to that of Starbucks Manufacturing Group ('SMC'), which was the only other entity to exercise roasting activities. It found that, based on the APA, SMC was x (confidential) times more profitable. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Third, assuming the profit level indicator was appropriate, the two adjustments in the transfer pricing report did not result in a reliable estimation of a market-based outcome. Using a 'working capital adjustment' and the excluding the costs mentioned earlier from the cost base which was then used as a profit level indicator was criticised by the Commission. All in all, the Commission then concluded that the Netherlands tax authorities had reduced SMBV's tax base by accepting the APA whereby SMBV's profits above the (confidential) % margin of operating costs were to be paid as a royalty to Alki. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Regarding the selectivity of tax measures which was the third step of the analysis, the Commission determined that the derogation was not justified. The burden of proof lies with the Netherlands authorities and Starbucks. Neither had offered any possible justifications for the selective treatment. The Commission thus concluded that all four conditions for the existence of State aid had been met. Under Article 108 (3), the Netherlands would have been obliged to notify the Commission of the APA. Since the Kingdom of the Netherlands had not complied, the Commission regarded it as unlawful State aid. The beneficiaries were the Starbucks group as a whole because they formed a single economic entity. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Since the State aid was unlawful, the Commission ordered the recovery of the aid. According to the Commission, SMBV's accounting profits should have been used to calculate its taxable profits since the royalty amount must be zero. Furthermore, the difference between what should have been paid for the green coffee beans and what was actually paid should be added to the taxable profits of SMBV. The amount of aid to be recovered was then the difference between the tax paid under the APA and the tax that ought to have been paid. The Kingdom of the Netherlands was required to recover the aid from SMBV. In the instance that SMBV was unable to make the repayment, the Kingdom of the Netherlands should recover the amount from Starbucks Corporation. The recovered sums were commanded to be calculated on a rolling basis and paid with interest from the date of disposal. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The Kingdom of the Netherlands claimed that the Court should abolish the decision and command the Commission to fund the costs of the case. The Commission argued that the Court should dismiss the application and order the Kingdom of the Netherlands to pay the costs. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Both the Kingdom of the Netherlands and Starbucks put forward pleas to seek annulment of the Commission's decision that the APA constituted State aid:

1. Starbucks and the Kingdom of the Netherlands do not agree with the Commission on the issue that the APA was selective. In their view, the Commission used the wrong reference system for determining the APA's selectivity.
2. Starbucks and the Kingdom of the Netherlands are of the opinion that the analysis made by the Commission which determined that the APA granted an advantage to SMBV is false.
3. Starbucks and the Kingdom of the Netherlands claim that the Commission breached the fiscal autonomy of Member States by examining whether there was

an advantage in regard to the AL principle specific to EU law. This also let to an infringement of Article 107 TFEU.

4. According to Starbucks and the Kingdom of the Netherlands the Commission also infringed Article 107 TFEU by concluding that choosing TNMM for determining a transfer price constituted advantage.
5. According to Starbucks and the Kingdom of the Netherlands the Commission again infringed Article 107 TFEU by wrongly considering the rules for the application of the TNMM approved in the APA to constitute an advantage to SMBV.
6. The Kingdom of the Netherlands alleges the Commission breached the principle of due diligence.

The General Court then set forth to examine the pleas raised by Starbucks and the Kingdom of the Netherlands and the arguments brought forward by the Commission. The Court concluded that, in essence, the Kingdom of the Netherlands and Starbucks only dispute that selective advantage was granted to SMBV through the APA. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

First, the Court inspected Starbucks' and the Kingdom of the Netherlands' claim that the Commission had not defined the content of the AL principle and that under the principle of equal treatment, the Commission had disregarded Netherlands' rules of tax law. They also argued that only the national rules of the Member States should be evaluated in regard to State aid control. Hence, the Commission was not entitled to use the AL principle in EU law to examine the APA. The Court viewed that even though direct taxation is within the competence of EU Member States, settled case law states that Member States are still obliged to exercise that competence in line with EU law. Previous case law also states that integrated companies should be treated in the same way as stand-alone companies. A certain level of pricing for intra-group transactions has been accepted by national authorities. The Commission is thus allowed, under Article 107 TFEU, to examine whether a tax measure is State aid and use the AL principle as a tool for checking whether the pricing corresponds to that under market conditions. In light of this, the

Court rejected the arguments of Starbucks and the Kingdom of the Netherlands regarding the Commission failing to define the content of the AL principle and that it had engaged in disguised tax harmonization through its description of the AL principle. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Next, the Court considered Starbucks' and the Kingdom of the Netherlands' complaints that the Commission could not deduce that traditional methods are prioritized over transactional methods by the OECD Guidelines. In their view, the Commission also wrongly claimed that logistics and administrative services are part of the APA when in reality, the APA only concerns the roasting of coffee beans. Examining whether the royalty is concordant with the AL principle is not the purpose of the APA. Both claim that choosing TNMM for calculating transfer pricing was the correct method because there was a lack of unrelated transactions, which would have been necessary if the CUP method was used. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The Court noted that the Commission had not acknowledged that transfer pricing had not been used to calculate the amount of royalty in the APA. The chosen method, TNMM, had only been used to calculate the arm's length remuneration for the production and distribution activities. The Court also noted that even if the choice of TNMM was wrong, it is not enough to prove there was an actual advantage. However, the Netherlands transfer pricing decree states that the entity is free to choose the transfer pricing method. Consequently, the Commission could not state that the CUP method should have been prioritized over the TNMM. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Regarding the argument of Starbucks and the Kingdom of the Netherlands that the Commission was wrong in stating that the royalty remuneration should have equalled zero and that the evidence the Commission had provided (namely comparable transactions) had not been available in 2008. Again, the Court sided with Starbucks and the Kingdom of the Netherlands, stating that they could not have included information that was not available at the time the APA was adopted and therefore examining whether there was an advantage conferred to SMBV should be established “in view of the context of the time at which the agreement was concluded”. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The Court then considered the Commission’s assertion that according to the roasting and licensing agreements Starbucks had with third parties as well as some agreements by Starbucks’ competitors, the third parties provided no royalty for the use of roasting IP, and therefore neither should SMBV have. Starbucks argued, saying most of the evidence was not available in 2008 and that the contracts used by the Commission mainly dealt with other coffee-related activities than roasting. The Court decided that Commission could not use information subsequent to the adoption of the APA in its analysis of the APA. Contracts that did not deal with roasting were also not accepted as comparable by the Court. In Starbucks’ defence, the Court stated that without the IP rights and thus without paying a royalty, SMBV would not have been able to produce coffee according to the specifications of Starbucks had it been an independent undertaking. The Court then concluded that the Commission had not been successful in proving the royalty paid by SMBV should have amounted to zero or that if the CUP method was applied based on the contracts between Starbucks and third parties, the arm’s length value of the royalty ought to have been zero. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Regarding the disagreement on the assumed overvaluation of the green coffee beans and Starbucks’ claim that the cost of said beans was outside the scope of the contested measure, The Court concluded that the contested measure was solely made up of the APA, which did not, like Starbucks claimed, determine the cost of green coffee beans. It then went on to state that the Commission could have covered the annual tax assessments in the contested measure but had chosen only to limit the coverage to the APA and therefore was not entitled to recover the difference between the income tax actually paid by SMBV and what ought to have been paid if the valuation of the green beans had been lower. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Next, the Court considered the Commission's argument that SMBV was, in fact, the most complex entity and therefore could not be used as the tested party for the purposes of TNMM and Starbucks' counterargument that SMBV's functions are less complex compared to Alki's as its activities are low-risk coffee roasting and inter alia logistical support. It found that the OECD Guidelines do not obligate an entity to choose the least complex entity as the tested party but recommend choosing the entity for which there is the most reliable data available. Nevertheless, nowhere in its arguments does the Commission prove that there was more reliable data available for Alki. Again, the Court sided with Starbucks and the Kingdom of the Netherlands. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

Regarding whether the choice of the profit level indicator provided an advantage to SMBV, the Court determined that the Commission's analysis did not suffice in proving that operating costs as a profit level indicator did not lead to an arm's length result. The Court also rejected the Commission's claim that sales should have been used as a profit level indicator on the basis that the Commission failed to demonstrate that the intra-group transactions of SMBV were so closely linked that a single pricing level could have been used to determine their remuneration. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

The Court determined, regarding the Commission's assertions that the adjustments made by SMBV were erroneous, that the Commission had been unable to prove that either the cost-based adjustment or the working-capital adjustment had constituted an advantage to SMBV. In conclusion, the General Court ruled that the decision of the Commission would be annulled on the basis that the Commission not been able to prove that a selective advantage had been granted to SMBV by the Netherlands authorities within the meaning of Article 107(1) TFEU. As the unsuccessful party, the Commission was ordered to pay its own costs in addition to those of the Kingdom of the Netherlands and Starbucks. (T-760/15, Starbucks Corp. vs Commission, EU:T:2019:669)

5.3 Fiat

Fiat Chrysler Automobiles is an Italian American multinational corporation with its legal headquarters in the Netherlands and its head office in the United Kingdom. In March 2012, the tax adviser of Fiat Chrysler Finance Europe, then known as Fiat Finance and Trade (referred to as FFT), a subsidiary of Fiat Chrysler Automobiles, requested a tax ruling from the Luxembourg tax authorities. FFT provides treasury services and financing to the Fiat/Chrysler group companies in Europe, excluding companies established in Italy. The head office of FFT is Luxembourg. Later that year, a tax ruling in favour of FFT was issued by the Luxembourg tax authorities, stating that the intra-group financing activity conducted by FFT had been concordant with the arm's length principle. The decision was binding for the next five years. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

In June 2013, the European Commission sent Luxembourg a request for detailed information on its national tax ruling practices. Due to a lengthy correspondence between Luxembourg and the Commission, a binding decision about requiring information was postponed until March 2014. The Commission started a formal investigation of the tax ruling under Article 108(2) TFEU. A decision was adopted in October 2015, when the Commission found that the tax ruling Luxembourg had granted to FFT was considered state aid. The Commission accused the tax ruling as a means to allow profit allocation to FFT within the Fiat Chrysler group. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

According to the Commission, FFT was involved in "market funding and liquidity investments, relations with financial market actors, financial coordination and consultancy services to the group companies, cash management services to the group companies, short-term or medium-term inter-company funding, and coordination with the other treasury companies." The tax ruling in question contained a request for approval of an advance transfer pricing agreement and a transfer pricing report, including a transfer pricing analysis. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The Commission remarked that according to the transfer pricing report provided by FFT, the most appropriate method for determining the taxable profit of FFT was the transactional net margin method (referred to as the TNMM). The TNMM considers the net margins by independent enterprises. According to the report, the decision was validated by the fact that FFT was providing financial services to Fiat Chrysler group companies only. According to the same report, the remuneration due to FFT had to be determined by reference to the capital FFT requires in order to perform its functions and bear its risks in relation to the assets in use. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

In the transfer pricing report, the proposed way of calculating the overall remuneration that FFT was entitled to for its activities concerning treasury and financing, and taking into account the risks that it bore, was with the following two components:

- FFT's hypothetical regulatory capital (EUR 28 500 000) multiplied by the pre-tax estimated return of 6,05% to form a 'risk remuneration'
- Multiplying an allocation of FFT's capital used to perform the functions (est. EUR 93 710 000) by an estimation of 0,87% which is the market interest rate applied to short-term deposits to form a 'functions remuneration'

The segment of FFT's equity allocated as supporting FFT's financial investments in Fiat Finance North America Inc. (FFNA) and Fiat Finance Canada Ltd. (FFC) was not to be remunerated according to the report, and the tax ruling by the Luxembourg authorities had endorsed this proposal. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The Commission noted that the tax ruling had been issued on the basis of Article 164(3) of the Luxembourg Income Tax Code. The Commission indicated that under Luxembourg tax law, transactions between companies under the same group were to be considered as independent companies in accordance with the arm's length principle. The Article also explained explicitly how to determine the arm's length remuneration in intra-group financing companies. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

OECD guidelines were outlined by the Commission stating that transfer prices referred to "prices charged for commercial transactions between various entities belonging to the same corporate group". Tax administrations may only accept transfer prices in accordance with the arm's length principle to avoid multinational companies having a financial incentive to designate as little profit as possible to jurisdictions with higher taxation. That principle was to be found in Article 9 of the OECD Model Tax Convention on Income and on Capital as pointed out by the Commission. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

According to the Commission, two out of five transfer pricing methods outlined in the OECD Transfer Pricing Guidelines were relevant for approximating an arm's length pricing in the case of FFT. The first of these was the CUP method, and the second was the TNMM. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The Commission stated that the tax ruling that gives FFT the possibility to determine its tax liability in Luxembourg on a yearly basis for five consecutive years constitutes aid within the meaning of Article 107. In accordance with Article 107(1) of the TFEU, the Commission considered the tax ruling as state aid as it fulfilled all four conditions laid out in the Article. The first condition, an intervention by the State or through State resources, was fulfilled as it was imputable to the Grand Duchy of Luxembourg. Furthermore, the ruling had resulted in a loss of tax revenue because of the reduction of FFT's tax liability. The second condition, the intervention must be liable to affect trade between the Member States, was fulfilled as the group FFT was a part of, was operating in all EU member states. Therefore, any aid given to the company could affect intra-union trade. The fourth condition, the intervention must distort or threaten to distort competition, was fulfilled as the tax ruling relieved the tax burden of FFT and thus also strengthened the finances of the company. The third condition, the intervention must confer a selective advantage on the recipient, the Commission viewed as fulfilled since the tax ruling granted to FFT was regarded as having resulted in a reduced tax liability for FFT in Luxembourg because the tax FFT would have been liable to pay under the ordinary corporate income tax system would have been higher. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

To determine whether the aid was selective, the Commission had again used a three-step analysis established in the previous case law. The first step, identifying the normal regime in the Member State, was observed to be the Luxembourg corporate income tax system. The objective of that system is to tax the profits of both domestic and foreign companies. The second step was determining whether the tax measure in question constituted a derogation from that system. In the Commission's view, if a tax measure results in an unjustified reduction of the tax liability of a beneficiary, who would otherwise be subject to higher taxation under the reference system, that reduction constitutes both the derogation from the reference system and the advantage granted by the tax measure. According to case law, the identification of economic advantage is principally enough to support the presumption that it is selective in the case of an individual measure. The third step of the analysis only comes into play if there is a derogation from the reference system. In that case, the State has to establish whether the nature of the reference system can justify that measure. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

In the Commission's view, there were several mistakes in the transfer pricing analysis in the tax ruling approved by the Grand Duchy of Luxembourg.

1. The chosen profit level indicator (the hypothetical regulatory capital) was not appropriate in the application of TNMM for estimating an arm's length remuneration. Instead of the hypothetical regulatory capital of EUR 28,5 million,

accounting equity should have been used, which was EUR 287,50 million in 2011. By using the former, FFT's taxable remuneration had been divided by 10.

2. FFT's hypothetical regulatory capital had been underestimated because of the mistakes made by the Grand Duchy of Luxembourg in the application of the Basel II framework.
3. Several deductions from FFT's remaining capital were made which departed from a marked-based outcome. If the hypothetical regulatory capital had been correctly estimated, no capital in excess of regulatory capital would have likely been found. The tax adviser of FFT had also isolated the equity component designated as 'equity supporting the financial investments in FFNA and FFC'. Then it was accorded to zero remuneration when calculating FFT's tax base. This was deemed inappropriate.
4. A beta of 0,29 chosen by the tax advisor of FFT when using the CAPM to calculate the return on capital which was to be applied to FFT's hypothetical regulatory capital resulted in a profit allocation that was not aligned with the AL principle.

The Commission thus concluded that the appropriate level of remuneration should be determined on the basis of FFT's accounting equity and that the required returns on capital in the financial sector are at or above 10 % and so the pre-tax return on equity of 6,05 % accepted in the tax ruling was below the requirement. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The Commission also rejected an argument by FFT stating that the Fiat/Chrysler group had not received any advantage because an increase in taxes in Luxembourg would result in an increased tax deduction in the other Member States. According to the Commission, neither FFT nor the Grand Duchy of Luxembourg had brought forward any justification for the selective treatment of FFT. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

Subsequently, the Commission concluded that the receiver of the advantage was the Fiat/Chrysler group as a whole. In the light of all of the preceding review, the tax ruling was concluded to constitute State aid in the form of operating aid and that the aid was incompatible with the internal market. The Commission also stated that the Grand Duchy of Luxembourg had failed to notify it, in accordance with Article 108(3) TFEU, of an intention to grant the tax ruling. Therefore, the tax ruling was considered to be unlawful State aid. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

Luxembourg was ordered to recover the incompatible and unlawful aid from FFT. The recovered sums were commanded to be calculated on a rolling basis and paid with interest from the date of disposal. If FFT was deemed unable to pay, the sum should be recovered from Fiat Chrysler Automobiles NV. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The Grand Duchy of Luxembourg and FFT filed a claim with the Court requiring the annulment of the contested decision and asking the Commission to be ordered to pay the costs. The Commission argued that the Court should dismiss the application and order the Grand Duchy of Luxembourg to pay the costs. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

In support of their actions, the Grand Duchy of Luxembourg put forward three pleas in law and FFT put forward four pleas in law. Luxembourg:

1. The Commission incorrectly considered the relevant reference framework to be the general corporate income tax regime and failed to demonstrate that the tax ruling derogated from that framework or from the AL principle. The Commission also infringed Articles 4 and 5 TEU and Article 114 TFEU by participating in tax harmonization in disguise.

2. The Commission infringed Article 107 (1) TFEU and the obligation to state reasons as provided for in Article 296 TFEU by failing to show that there was any advantage or any distortion of competition.
3. The Commission ordered the recovery of aid contrary to the principle of legal certainty.

FFT:

1. The Commission infringed Article 107 TFEU by misapplying the concept of selective advantage in four ways: the relevant reference framework was erroneous, an unprecedented and undefined AL principle was applied, there was no proof of an advantage to Fiat/Chrysler Group and that even if there was a derogation of the framework, it was justified.
2. The Commission infringed the second paragraph of Article 296 TFEU by failing to state reasons through its failure to explain how it derived from the AL principle and what that principle is. The Commission also failed to detail how the tax ruling distorted competition in its view.
3. The Commission breached the principle of legal certainty due to its formulation of the AL principle and when a tax ruling might be considered State aid.
4. The Commission breached the principle of protection of legitimate expectations by not assessing the tax ruling in the light of the relevant OECD rules.

The Court examined the pleas and concluded that the Commission could deem a tax measure as State aid if the conditions are met. According to settled case law, areas that have not been harmonized in the EU, like direct taxation, are not excluded from the scope of the rules on the monitoring of State aid. Thus, if a tax ruling discriminates between companies in comparable situations, the Commission is well within its right to monitor compliance with Article 107 TFEU. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

Also, according to settled case-law, measures which can directly or indirectly favour certain ventures or give an economic advantage that the recipient would not have received under normal market conditions are regarded as State aid, specifically, if the measure is given by a public authority even if it does not involve the transfer of State resources. Thus, the Court rejected the plea intended to establish that the Commission had engaged in tax harmonization in disguise. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The Court also rejected FFT's argument that the Commission did not provide any legal basis for the AL principle on the basis that the Commission had stated that the AL principle it applied was that in Article 9 of the OECD Model Tax Convention but that it was also a general principle of equal treatment in taxation. The Court stated that the Commission is not formally bound by the guidelines in response to FFT's argument of the Commission having disregarded a paragraph according to which appropriate adjustments can be made in the application of TNMM. According to the Court, the Commission had not prohibited appropriate adjustments but simply stated that they were not justified in the case of FFT. In the case of the AL principle bringing forth legal uncertainty as claimed by FFT, the Court stated that the concept of State aid is defined and that the Commission did not conclude that all tax rulings constitute State aid, but only those providing a selective advantage. The Court thus rejected the complaints by FFT and Luxembourg concerning the AL principle. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The General Court then inspected the disagreement between the Commission on the one side and FFT and the Grand Duchy of Luxembourg on the other side concerning the level of FFT's remuneration for its intra-group transactions. The Court observed that in principle, the parties only disagree, in the context of TNMM, on assigning capital to particular functions that are subject to different return rates. According to the OECD Guidelines, the Court sided with the Commission stating that "it is assets and not the capital that may be isolated" and allocated to specific risks or capital. Even though the profitability of capital as well as that of the assets are accepted as an indicator in TNMM, it does not mean that capital may be treated the same way as operating assets as capital is fungible and exposed to risk regardless of the activities, unlike operating assets. However, as the segmentation of capital of an integrated company is not expressly authorized nor prohibited, the Court decided also to observe whether the segmentation of the capital was appropriate. The Court concluded that the segmentation was based on an "entirely artificial analysis of the use of FFT's equity". As long as the whole capital is available to support FFT's solvency, it is also exposed to risk and hence should be remunerated in full. The Court also stated that when FFT borrows on the market, its whole capital is taken into consideration by the market operators from which it borrows. The segmentation did not take into account that the taxable profits of FFT will vary depending on its borrowing costs which again depend on the size of its capital. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The Court also rejected Luxembourg's argument that the Commission was wrong to consider that the hypothetical regulatory capital of FFT should not have been used as a base for a risk remuneration calculation. In its view, the fact that FFT as a financing company was obliged to have a minimum capital does not in itself justify the minimum capital constituting an appropriate profit level indicator since a regulatory obligation has no connection with the shares of profits obtained. The Court also noted that in the transfer pricing report, the choices for comparison companies with FFT were not based on the hypothetical regulatory capital. It thus concluded that the capital actually taken into account in the methodology used by the tax ruling, and the total capital differs so significantly that it necessarily eases FFT's tax burden. Consequently, the Court found that the disagreement on the rate of return was irrelevant as the resulting remuneration would still be considerably higher when applied to the full amount of capital. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

Next, the Court considered the Grand Duchy of Luxembourg's and FFT's claim that the Commission had not demonstrated that there was any advantage given to the

Fiat/Chrysler group and that the Commission had thus infringed its obligation to state reasons as per Article 296 TFEU. First, according to case law, the Court found that the lowering of a tax burden in one Member State (in this case Luxembourg) resulting in a higher tax burden in another Member State does not affect the fact that the measure can be categorized as aid. The Court also noted that the amount of tax paid by FFT influenced the pricing conditions of intra-group loans given to it. Hence, reductions in FFT's tax liability would reduce the pricing conditions of its intra-group loans. The Court thus rejected the Grand Duchy of Luxembourg's and FFT's claims. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

After that, the Court examined whether the Commission was entitled to presume that the aid was selective. The Court started by stating that the existence of an advantage was evident and hence the first condition for determining selectivity had been met. Next, the Court examined whether the second condition of the aid having to constitute individual aid was met. It pointed out that even though the tax ruling was part of a large number of tax rulings, the fact that the tax ruling at issue granted an advantage to FFT was enough for it to constitute individual aid. In that light, the Court found that the Commission had been entitled to state that the tax ruling at issue was selective. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

Next, the Court examined whether there was a restriction of competition as the Commission had found. According to case law, aid releasing an undertaking from costs it would have typically had to bear distorts competition. It is also settled case law that the effect on trade between the Member States does not have to be real. There only needs to be a possibility for the aid to affect trade for it to be considered State aid. The Court also rejected FFT's submission that even if it benefited from lower taxation in Luxembourg, it does not provide services to third parties and thus does not have a competitive stand in any market. Because a reduction in FFT's tax burden means that it can finance the other group companies at a lower cost, competition may be distorted. Again, the

Court found that the pleas put forward by the Grand Duchy of Luxembourg and FFT were unfounded. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

The final plea the Court considered was relating to the recovery of the aid. The Grand Duchy of Luxembourg claimed that the Commission had breached the principle of legal certainty by ordering the recovery of the aid in question. The Court concluded that there was no reason why FFT or the Grand Duchy of Luxembourg would assume the Commission would not apply Article 107 TFEU to tax rulings, and any aid that fulfils the conditions of that Article would be subject to recovery. Regarding the Commission failing to state an exact amount of aid to be recovered, The Grand Duchy of Luxembourg argued that there is no one correct transfer price but a broad range of correct transfer prices according to the OECD. Since the Commission had not given an exact amount of aid to be recovered because the exact amount of aid cannot be assessed, it should not be recovered. The Court rejected this argument, stating that the Commission had come up with a methodology for eliminating the advantage granted to FFT if they chose to use the TNMM but that they were also allowed to use an alternative method for the calculation. The Court, again, rejected the plea and finally stated that cases must be dismissed. Under Article 134 (1) of the Rules of Procedure, the unsuccessful party must bear its own costs and those incurred by the Commission. (T-755/15, Fiat Chrysler Finance Europe vs Commission, EU:T:2019:670)

6 Findings & discussion

When examining the General Court Cases described in the previous chapter, distinct differences in perspective between the European Commission and the MNE's (Starbucks and Fiat) were clearly distinguishable. The key differences were the following:

- What constitutes selective advantage as defined in Article 107 TFEU
- The choice and application of the transfer pricing method
- Whether the AL principle should be used as defined in Article 9 of the OECD Model Tax Convention or as defined in national legislation of the Member States
- What can be classified as tax harmonization in disguise
- What is sufficient for an explanation of reasons under Article 296 TFEU

These view differences are examined individually in the following paragraphs.

In both of the General Court Cases, the MNEs are in disagreement with the Commission over what can be regarded as an advantage and, more specifically, selective advantage. The Commission had, in both instances, determined that the tax rulings given by the authorities of Luxembourg and the Netherlands conferred a selective advantage to Fiat and Starbucks by lowering their tax liabilities in their respective States. To determine the selectiveness, the Commission had used a three-step analysis settled in the previous case law.

In the case of Fiat, the company argued that the Commission had misapplied the concept of selective advantage by using the wrong reference framework and by providing no proof that there was an actual advantage granted to the Fiat/Chrysler group. Starbucks, too, argued that the reference framework the Commission had used was wrong. The Commission, on the other hand, had stated that Article 164(3) of the Tax Code and the Circular under Luxembourg tax law was the correct reference framework in Fiat's case as it laid down the AL principle under Luxembourg law. In Starbucks' case, the Commission regarded the general Netherlands corporate income tax system as the correct reference system. In Starbucks' view, the Commission made its assessment in light of the AL principle instead of the national tax law.

Since, in the Commissions view, both Fiat and Starbucks had derogated from the reference system by not being concordant with the AL principle and hence been subjected to a reduced tax liability, which in its opinion was not justified, the advantage had been granted to both entities. The Commission had also referred to the previous case law where if an economic advantage can be identified, then in principle, that advantage can also be presumed to be selective. In Fiat's perspective, there was no derogation, and even if there was, it was justified. Starbucks argued the same. It must be noted, at this point, that the burden of proof related to justifying a derogation lies on Starbucks and Fiat, and according to the Commission, neither company had provided any justifications. The question then was only on whether the Commission could actually prove that there, in fact, was a derogation as the burden of proof in that regard lay with it.

It can be concluded from the Commission's and the MNEs' arguments that it is quite challenging to assess selectivity in taxation issues. What makes it difficult is, on the one hand, analysing the relevant tax regime, and on the other hand, determining what the correct tax regime actually is. The Commission's statement that a presumption of selectivity can be made if an economic advantage can be established is true, except in a case where the advantage can be justified. The cases, however, leave open what would constitute such a justification. Nevertheless, it is clear that the Commission views tax rulings, which in its opinion do not reflect economic reality, as State aid. MNEs, in contrast, view these tax rulings as part of a general system that does not, on the basis of that, constitute individual aid. It is easy to understand both perspectives. Starbucks and Fiat view a tax ruling by a national government as just one of many tax rulings. As all entities are entitled to apply for advance tax rulings, the ruling regarding them is not individual per se. In contrast, the Commission's take on it is that the ruling is individual aid as the sole beneficiary of the ruling was the entity requesting it.

When it comes to State aid and selective advantage, it is also interesting to note that the Commission does not actually have to prove that competition among EU member states was distorted, only that there was a possibility for the distortion. That, in effect, means that any advantage granted by national governments can constitute State aid in the event that all other conditions are met if the advantage strengthens the financial position of a company. The mere fact that a company's financial position is stronger is enough to suggest that its position on the market is also stronger. Therefore the "natural" state of competition suffers.

Closely linked with determining selectivity is the Commission's criticism of the choice of the transfer pricing method as well as the application of the said method in the case of Starbucks and the application of the chosen transfer pricing method in the case of Fiat. In Starbucks' case, the Commission had argued that the correct choice of a transfer pricing method to be used in the APA, in order to determine the level of royalty, would have been the CUP method instead of the TNMM that was actually used. That was based on the Commission's assertion that the OECD Guidelines prefer the use of traditional transaction methods, like the CUP, instead of the transactional profit methods like the TNMM. Moreover, as according to the Commission, there had been comparable transactions available, it was enough reason to give priority to the CUP method over the TNMM. In Fiat's case, however, the Commission had agreed on the use of TNMM to determine Fiat's taxable profit but disagreed as to the profit level indicator chosen for the application of TNMM, stating that the profit level indicator used by Fiat had divided its remuneration by ten and therefore was not concordant with the AL principle.

Starbucks had argued the opposite and stated that TNMM was the appropriate method given that there was a lack of comparable transactions. Fiat, in turn, had argued that the application of TNMM was correct and that the method itself requires for the segmentation of capital and, therefore, the use of the hypothetical regulatory capital as the profit level indicator was appropriate.

The OECD guidelines do state that entities are free to choose the transfer pricing method as long as it is concordant with the AL principle, so Starbucks' criticism towards the Commission on trying to argue that a particular method, in this case, the CUP method, should have been chosen is valid. If the Commission were allowed to determine which transfer pricing method was to be used by the entities, that would undoubtedly breach the principle of legal certainty. It would be entirely up to the Commission to assess the correct method based on each individual case. As discussed in chapter three, the CUP method does, as Starbucks claimed, require comparable transactions. If there were none or not enough available, it would be reasonable to use a method like TNMM that does not require comparables. In Fiat's case, however, it is understandable that the Commission would check the application of the chosen method as even the OECD guidelines lay down rules and suggestions for the application. Furthermore, as stated at the beginning of this chapter, the chosen method, TNMM at hand, needs to result in an arm's length price. Therefore, it is entirely logical that the Commission would assess the application of the method to see whether it was correctly applied and hence in line with the AL principle.

It must also be stated that the EU General Court ruled, in the case of Starbucks, that mere noncompliance with methodological requirements was not enough to conclude that the company had actually received an advantage. This ruling would seem to give the Member States some extent of latitude to ensure the pricing within a relevant range complies with State aid rules.

Both Fiat and Starbucks disagreed with the Commission on the use of the AL principle altogether. The AL principle is defined in both Luxembourg and the Netherlands tax law. The criticism was towards the Commission using a vague concept of the arm's length principle, particular to EU law and not the national law of the states in question. The Commission believed that it was entitled to, under Article 107 TFEU, to assess tax measures using the AL principle. It was applying the AL principle as a general principle of equal treatment in taxation. The MNEs viewed it as a breach of their fiscal autonomy since their national law was not taken into account.

Since both the Netherlands as well as Luxembourg tax law actually do recognize the arm's length principle, and it is relatively similar to the one used by the Commission, this line of reasoning by the MNEs was unforeseen. Luxembourg tax law states that transactions between associated companies must be remunerated in the same way as transactions between independent undertakings in comparable situations. The Netherlands tax law states that the AL principle is based on comparing the conditions of transactions between associated companies to those of unassociated companies. Thus, in essence, the AL principle does not substantially differ from the one in Article 9 of the OECD Model Tax Convention used by the Commission.

Related to the usage of the AL principle found in Article 9 of the OECD Model Tax Convention is the claim made by Starbucks and Fiat that the Commission engaged in tax harmonization in disguise. Their claim is, in essence, that by applying an arm's length principle different from that of the national law, the Commission infringed Article 114 TFEU and Articles 4 and 5 TEU which basically state that direct taxation falls under the competence of the Member States. The Commission, in contrast, viewed the application of the arm's length principle as an integral part of its assessment of selective advantage and furthermore stated that the AL principle was used as a sort of “benchmark” to determine whether an intra-group company was receiving an advantage within the meaning of Article 107 TFEU.

Article 4 TEU, to which Starbucks and Fiat referred to, includes the national identity clause by which the Union is obliged to respect the national identities of the Member states. The Article in itself is ambiguous as to its scope. However, if it were to be regarded as an Article capable of challenging EU law, then the arguments of Starbucks and Fiat would probably hold. It is clear from the MNEs' arguments that they consider tax rulings given by national governments to only be the domain of those governments and that EU law should not and could not supersede national tax law. However, as ruled by the General Court, the Commission is allowed to investigate whether tax rulings given by national governments would be prohibited under State aid rules.

Moreover, the AL principle can be used as a tool to discover whether a tax ruling entails State aid, but only if the principle can be found in the national tax laws of the State being investigated. It is clear that if the EU Commission was not allowed to investigate tax rulings, then upholding State aid rules would be near impossible. That would also mean that governments would be able to lure companies to their respective State by giving them beneficial tax rulings, which would not lead to fair and free competition.

The Commission and the MNEs were also in disagreement over what constituted a plausible statement of reasons under Article 296 TFEU. In Fiat's view, the Commission had failed to show it had received advantage and that there was any restriction to competition. Starbucks, on the other hand, argued that the Commission had not given proper reasoning to its conclusion that Starbucks had used the wrong company as a tested party, and that led to a reduction in taxation for Starbucks. In the case of Fiat, the Commission had counterargued that as Fiat's tax liability had been lowered by the tax ruling granted to it, that already counted as an advantage and therefore was liable to distort competition. In the case of Starbucks, the Commission had stated that the error made with the choice of the tested party led to a reduction in taxes for Starbucks.

Article 296 TFEU requires the Commission to clearly articulate reasons for the adopted measures. The sufficient reasons always depend on the case at hand and the surrounding context. When comparing the cases of Starbucks and Fiat, it is apparent that merely stating that some form of doing (like in the case of Starbucks) is erroneous is not enough to satisfy the statement of reasons within the meaning of Article 296 TFEU. Even though the Article does not require the reasoning to go deeply into points of law, it does require the Commission to justify why it has deemed its decision legitimate. For example, in the case of Starbucks, the Commission had not stated why it had concluded that the error in the choice of the tested party led to a reduction in taxes, and thus, the General Court ruled that the Commission had not fulfilled its obligation in that regard. Such a justification is crucial when looked at from an intra-EU viewpoint to justify why, in this case, the Commission was more competent than the national authorities. It can also be seen as crucial for upholding the relationship between the European Union and its Member States by offering legal protection to the Member States.

In light of these findings, the answers to the research questions presented in Chapter one, are as follows:

1. *How has the European Commission intervened in the transfer pricing practices of multinational entities?*

The European Commission has enforced State aid rules, specifically in the area of tax rulings. The Commission has sought to use the AL principle as a tool for determining whether the tax rulings granted by national authorities constitute State aid within the meaning of Article 107 TFEU. The Commission has questioned the choice and application of transfer pricing methods by the MNEs, and preference was given to traditional transaction methods rather than transactional profit methods. To demonstrate that aid has been granted, the Commission has analysed the tax rulings and attempted to prove that the MNEs gained an advantage from the tax rulings in the form of lower tax liability. With these actions, the Commission has strived to limit unlawful profit allocation and ensure that all companies pay their “fair share” of taxes.

2. *What is the basis for the way the transfer pricing decisions are made in the multinational entities?*

The MNEs have primarily based their transfer pricing decisions on the national law of the State they are established in. The tax advisors of the multinational entities have pursued advance pricing agreements with the local governments in order to comply with the national rules and law undoubtedly. Moreover, the advance pricing agreements have served as a way for the companies to estimate the amount of annual corporate income tax.

The finding that, despite direct taxation falling under the scope of the EU Member States, the Commission is allowed to examine the tax rulings of national governments under Article 107 TFEU is the reason for the fundamental difference of point of view between the European Commission and the MNEs. As the MNEs have examined their transfer pricing practices in light of national legislation and the European Commission under EU law, with regard to national legislation, different viewpoints are bound to arise.

The results are not surprising. Even though there are no previous studies on this specific subject, Horst’s (1971) suggestion that the optimum price for an MNE is the lowest or the highest possible permitted by government rules and tax regulations would support the assertion that MNEs base their transfer pricing decisions on national legislation. A survey by the European Commission (1997) concludes that State aid is a risk to the functioning of the internal market as well as a means to distort competition which is why the Commission should be more efficient and stricter with its State aid controls. That would support the Commission’s view of its right to intervene in national tax rulings.

7 Conclusion

The main objective of this thesis was to analyse the different viewpoints of the European Commission and the MNEs regarding the laws surrounding transfer pricing. Prior transfer pricing research has primarily focused on the behaviour of MNEs as well as their reactions to transfer pricing regulation. The difference in perspectives between the European Commission and the MNEs has not been subject to prior research.

The transfer pricing practices of MNEs operating in the EU area have been the subject of a more thorough investigation on the European Commission's part in recent years. The Commission has challenged and fined MNEs on their choice and application of transfer pricing methods, and the MNEs have taken the decisions of the Commission to the EU General Court seeking for annulment. The empirical research in this thesis was conducted by analysing two EU General Court Cases concerning tax rulings granted to Starbucks and Fiat and comparing the Commission's arguments to those of the MNEs'.

By examining the two different court cases, five distinct viewpoints were identified as contradictory between the MNEs and the Commission. They dealt with, in no particular order:

1. Selective advantage
2. Transfer pricing methods
3. AL principle
4. Tax harmonization in disguise
5. Statement of reasons

Some of the arguments by the Commission as well as the MNEs regarding these five points overlapped since they are all connected through the relevant legislation.

MNEs have conducted their transfer pricing practices according to the national legislation, and with the approval of the national authorities of the Member State, they are established in. The Commission, in turn, has based its decisions on EU law to restrict profit allocation to countries of lower taxation and, consequently, prevent the distortion of competition within the Union. The critical issue, and in some ways the root cause for the disagreement, was thus whether or not the Commission was actually allowed to interfere with national tax rulings since, according to EU law, direct taxation is the domain of the Member States. In the event that the MNEs had known the Commission was allowed to investigate national tax rulings, the differences in perspectives between the Commission and the MNEs may not have varied as much.

7.1 Limitations

In examining the limitations of this empirical research, validity and reliability must be assessed. The research methods are examined through validity, which aims to determine how well the used methods measure the subject at hand and reliability, which indicates how well the results can be repeated (Tuomi & Sarajärvi 2009, 142). There are conflicting views on the use of these terms in qualitative research, but the reliability of the research must nevertheless be assessed.

The arguments of the Commission and the European parliament in only two out of eight General Court cases were analysed and compared. The results may have differed if more cases were examined. The case material in itself is objective, as they are real court cases, and the author's opinions could not, therefore, influence the collection of the material.

The key findings are affected by what the author deems essential, so had the empirical research been conducted by someone else, the results may have varied.

7.2 Suggestions for future research

As the fundamental difference in viewpoint was whether or not the Commission was allowed to question the tax rulings of national governments, future studies could focus on how the ECJ has ruled in the transfer pricing cases concerning the EU Member States and multinational companies. The judgements from the ECJ could set an important precedent on how far the EU can question the tax decisions of national governments.

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