A NEW ERA OF STATE AID

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In August 2016, the European Union's (EU) Commission dropped a bombshell: it would require Ireland to collect more than $14.5 billion in back taxes from Apple under anti-subsidy rules that most Americans had never even heard of—the state-aid rules. Suspicions that certain EU Member States colluded with large multinationals to help them evade other states' taxes suggests the need for a supra-national authority that could curb harmful state tax practices. At the inception of a new and potentially transformative type of tax enforcement, this Article argues for a conservative approach that would preserve the requirement that, to be state aid, a Member State subsidy must discriminate.

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I. Introduction

The global financial crisis closed the spigot on tax revenues at a time of unprecedented government spending on bailouts and economic recovery. Sorely needing revenue, the governments of the world scrutinized corporate tax avoidance. As part of this scrutiny, the Senate's Permanent Subcommittee on Investigations called on executives from major U.S. multinationals to testify about tax planning techniques.[2] Apple caused a sensation in those hearings when it revealed that its most profitable foreign subsidiaries paid taxes nowhere on earth.

Spurred by the Senate's investigation, a small group of European Union (EU) Commission economists began to investigate Ireland's treatment of Apple under the EU's state-aid rules. The Treaty on the Functioning of the European Union (TFEU) prohibits Member States from granting state aid—subsidies to enterprises that distort private competition.[3] The state aid rules apply in all areas, not just tax, but the Commission has long taken the position that when a state grants an enterprise tax relief, it can be state aid.[4] The Commission concluded that Ireland violated the state-aid rules by issuing secret administrative rulings

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[2] *See Offshore Profit Shifting and the U.S. Tax Code- Part 2 (Apple Inc.)* 113th Cong. 2 (May 21, 2013) (memorandum to the members of the Permanent Subcte on Investigations from Senators Levin and McCain), [hereinafter Senators' Apple Memo] . Similar British parliamentary hearings lead to widespread boycotts of Starbucks stores in Britain to protest of the company's maneuvers to avoid British tax. HOUSE OF COMMONS, COMM. OF PUBLIC ACCOUNTS, HM REVENUE & CUSTOMS: ANNUAL REPORT AND ACCOUNTS 2011-12 (19th Rep. Sess. 2012–13).

[3] Treaty on the Functioning of the European Union, Oct. 26, 2012, 2007 O.J. (C 326) 91 [hereinafter TFEU], art. 107(1), (prohibiting state aid). *See* discussion, *infra* Part II.

[4] *See* discussion *infra* part II.D.

to Apple that allowed the company to pay too little Irish tax.[5] Ireland's punishment for aiding Apple was that it had to collect from Apple the proper back taxes, plus interest, going back ten years. If collected, the Apple recovery would be not only the largest tax deficiency in world history—at $14.5 billion plus interest[6]—but also the largest state-aid recovery in history.[7] Pierre Moscovici, the EU's Commissioner for Tax, called the Apple decision "a watershed moment. It sends out the signal that the era of large-scale tax avoidance by multinationals in Europe has ended."[8] In other recent cases, the Commission ordered recoveries from Amazon, Chrysler-Fiat, and Starbucks.[9] More cases are pending.[10]

Before 2014, the Commission brought few state-aid cases against U.S. multinationals, so U.S. lawyers were perhaps rationally ignorant of the state-aid rules. Likewise, U.S. lawmakers were caught off-guard by the recent cases.[11] Highlighting the Commission's seemingly disproportionate investigation of U.S. multinationals, Republican lawmakers condemned the Apple decision as "awful," "ludicrous," "an attack on all U.S. companies doing business globally," and "troubling for transparent, representative government." [12] Republican House Ways and Means Chair Kevin Brady criticized the investigations as "completely irresponsible;" he

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[5] *See* Commission Decision 2017/1283 of Aug. 30, 2016 on State Aid Implemented by Ireland to Apple, 2017 O.J. (L 187) 1 [hereinafter *Apple*].

[6] Neil Chenoweth, *Interest Bill is Apple's Next Problem*, AUSTRALIAN FIN. REV. (Sept. 2, 2016), at 10 (estimating recovery with interest at over $20 billion).

[7] Sean Farrell & Henry McDonald, A*pple ordered to pay €13bn after EU rules Ireland broke state aid* laws, THE GUARDIAN (Aug. 30, 2016) (noting that the Apple recovery order was "40 times the previous record for such a case and the equivalent of the annual budget for Ireland's health service").

[8] Alexander Lewis, *Apple's Income Should be Taxed in U.S., Not Ireland, Lew Says, TAX NOTES INT'L* (Sept. 5, 2016).

[9] The largest of the recoveries in these cases is against Amazon. Commission Press Release, *State Aid: Commission Finds Luxembourg gave illegal tax benefits to Amazon worth around €250 million* [hereinafter Commission's *Amazon* Press Release] (€250 million is about $294 million).

[10] Margrethe Vestager, Commissioner of European Commission, Speech to TAXE 2 Committee (April 4, 2016) [hereinafter Vestager Speech to TAXE], at 2.

[11] Robert Stack, who was Deputy Assistant Treasury Secretary for International Tax Policy when the Commission issued its recent state-aid decisions against U.S. multinationals, described himself as "learn[ing] to my extraordinary pain while I was in government [that EU Treaty rules] are superior to the rules of the [tax] treaties that the countries adopt."). *See* NYU School of Law, *22nd Annual David R. Tillinghast Lecture on International Taxation: Robert B. Stack*, YouTube (Sept. 22, 2017), https://youtu.be/zcdeiTL-gFE?t=1h1m27s.

[12] Dylan F. Moroses, *House and Senate Taxwriters Denounce Apple State Aid Ruling*, TAX NOTES INT'L (Sept. 5, 2016) (quoting, respectively, Senator Ryan, Congressman Tiberi, Senator Portman, and Senator Barrasso).

blasted the Commission for "pursuing a far-reaching tax policy agenda."[13] Democrats were equally harsh. Senator Schumer called the Apple decision a "cheap money grab," while Senator Wyden said the decision "set a dangerous precedent that undermines our tax treaties and paints a target on American firms in the eyes of foreign governments."[14] President Obama warned of the "danger... if one of us acts unilaterally."[15] Even the Treasury Department entered the fray, issuing a remarkable White Paper that argued that the recoveries would violate tax treaties between the United States and individual Member States.[16] The United States unsuccessfully sought to intervene in the upcoming *Apple* appeal, [17] an unprecedented move that one commentator criticized as turning Treasury into "a de facto lobbyist for Apple."[18] The entire saga has seriously strained U.S.-EU relations, with members of Congress asking Treasury to consider imposing retaliatory taxes on the EU, and commentators predicting a "tax war" between the United States and Europe.[19]

Few scholars in the United States or Europe have studied the impact of state-aid rules on U.S. multinationals.[20] But if the Commission

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[13] Brady Statement after Meeting with Commissioner Vestager, Press Release (Sept. 20, 2016) available at https://waysandmeans.house.gov/brady-statement-meeting-commissioner-vestager/.

[14] Dylan F. Moroses, *House and Senate Taxwriters Denounce Apple State Aid Ruling*, TAX NOTES INT'L (Sept. 5, 2016).

[15] Stephanie Soong Johnston, G-*20 Leaders Talk Tax Avoidance in Wake of Apple Decision*, TAX NOTES (Sep. 7, 2016). President Obama went on to note that the EU's efforts "may also have an effect in terms of our ability to collect taxes from that same company so you might end up in a situation where they pay into Europe and [the] U.S. Treasury is shortchanged'). *Id*.

[16] U.S. DEP'T TREASURY, THE EUROPEAN COMMISSION'S RECENT STATE AID INVESTIGATIONS OF TRANSFER PRICING RULINGS (Aug. 24, 2016) [hereinafter TREASURY WHITE PAPER].

[17] Order of the General Court in Case T-892/16, Apple v. Commission, ECLI:EU:T:2017:925 (denying the United States leave to intervene because it could not show imminent injury).

[18] Dan Bucks, *Is the Profit-Shifting Jig Finally Up?* TAX NOTES (Jan. 4, 2017).

[19] Lee Sheppard, *Notes from the Tax Wars*, TAX NOTES INT'L (Oct. 3, 2016). At 16 (reporting use of this term by commentators and academics).

[20] The recent cases have inspired a flurry of publications on tax and state aid, although they do not focus on the U.S. implications. *See*, *e.g.,* STATE AID LAW AND BUSINESS TAXATION (Richelle, et al., eds. 2016); In addition, state-aid scholars have long addressed the tax aspects of state aid. *See*, *e.g.,* CLAIRE MICHEAU, STATE AID, SUBSIDY AND TAX INCENTIVES UNDER EU AND WTO LAW (2014); CONOR QUIGLEY, EUROPEAN STATE AID LAW 97-153 (2015). Articles focused on the U.S. implications have begun to appear in practice journals, see, e.g., Ruth Mason*, An American View of State Aid*, 157 TAX NOTES 645 (2017); Daniel N. Shaviro, *Friends Without Benefits?: The Treasury and EU State Aid*, TAX NOTES INT'L (Sept. 19, 2016).

makes good on its promise to continue to closely examine Member State income taxes as potential state aid,[21] then American lawyers need to understand European law, and fast.

Until recently, the Commission has applied the state-aid rules similarly in tax and non-tax cases—namely, to prevent Member States from distorting private competition by granting "selective" advantages to particular companies or groups of companies.[22] Selectivity is best understood as a nondiscrimination rule, and doctrine reveals that discrimination on the basis of what this Article calls suspect classifications—including size, sector, nationality, and whether the enterprise engages in cross-border commerce—generates the most serious state-aid concerns.[23]

This Article shows that the Commission is moving away from traditional selectivity analysis. The Commission seeks to replace selectivity's traditional *domestic-law reference base* with a *normative reference base.* Under the domestic-law reference base, a state confers illegal state aid only when it grants to members of a suspect class benefits that are unavailable under normal domestic law. In contrast, under the normative reference base, a state confers illegal aid whenever it deviates from the Commission's view of good tax policy. The Commission won approval for this approach in the controversial 2011 *Gibraltar* case.[24] In *Gibraltar*, the Court of Justice shocked observers by affirming the Commission's decision that Gibraltar conferred illegal aid by assessing a property and sales tax regime rather than a more typical corporate income tax. The case was controversial because it suggested that, in addition to requiring Member States to apply their tax rules evenhandedly, the state-aid rules also place *content restrictions* on Member State tax policy choices.[25] *Gibraltar* suggests that some tax bases are illegal, even when they are not selective.

Accepting an interpretation of the state-aid rules that is unconstrained by the selectivity requirement would put broad tax

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[21] Vestager Speech to TAXE, *supra* note 10.

[22] COMMISSION NOTICE ON THE NOTION OF STATE AID AS REFERRED TO IN ARTICLE 107(1) OF THE TREATY ON THE FUNCTIONING OF THE EUROPEAN UNION, O.J. (C 262) 1, at paras, 117 to 184 (July 19, 2016) [hereinafter 2016 NOTICE] (describing selectivity).

[23] *See* discussion, *infra* Part II.A-D.

[24] Joined Cases C-106/09 P and C-107/09 P, Gibraltar, ECLI:EU:C:2011:732. *See* discussion, *infra* Part IV.A.

[25] *See, e.g.,* Daniel S. Smit, *International Juridical Double Non-Taxation and State Aid*, 2016 EC TAX REV. 109, 111 (calling the approach in *Gibraltar* "radical").

policymaking powers in the hands of the Commission, enabling it to strike down Member State tax rules that fail to comply with the tax-policy preferences of Commission staff. This Article argues that before narrowing or jettisoning the selectivity requirement, it is worth thinking about what role selectivity plays in state-aid analysis and how the Commission's new approach will impact the EU and the rest of the world.

This Article proceeds as follows. Part II provides background on state-aid law and explains that, despite conferring ever more authority to the EU via successive treaties, the Member States have steadfastly retained control over tax policy. Part II also identifies state-aid values and provides a history of state-aid enforcement in the tax area that emphasizes the importance of selectivity in past cases.

Part III argues that judges and commentators have failed to appreciate the role selectivity plays in properly channeling state-aid control. In addition to promoting equality of treatment and reducing state-induced distortions of competition between private enterprises, selectivity plays a less intuitive role. Selectivity essentially works as an internalization requirement. To avoid characterization as state aid, states must apply their policies without discrimination, which, in turn, forces states to internalize more of the costs of those policies than they would if they could discriminate. For example, a state hoping to lure business from a neighboring state might offer out-of-state businesses a special low tax rate. To keep costs down, however, the state might limit the special rate to foreign businesses, while continuing to tax domestic companies at regular rates. Because it discriminates on the basis of a suspect classification—corporate nationality—the rule would be selective under the traditional account. To avoid characterization as state aid, the state would have to offer the low rate to both foreign and domestic companies, which would raise the costs to the state of that policy, thereby discouraging it.

Thus, the selectivity requirement encourages states to internalize more of the costs of their competitive tax and regulatory policies than they would if they could discriminate. At the same time, however, the selectivity requirement does not constrain Member State autonomy as much as would the Commission's proposed normative-reference-base approach under which, to give an extreme example, the Commission might identify a tax-rate floor. In contrast with a normative approach, the domestic-law approach leaves major tax policy decisions—such as whether to have a property tax or an income tax, and whether to have high or low tax rates—to Member State democratic processes. As a result, it secures for the EU more of the benefits of tax (and regulatory) competition than would a normative-base approach.[26]

Part III also explains that selectivity helps ameliorate some concerns about the Commission's lack of democratic accountability and tax policy expertise. Analogizing Commission state-aid control to judicial review, I first argue that because the Commission's state-aid powers are counter-majoritarian, they should be construed narrowly, including by retaining the selectivity requirement.[27] Second, I argue that the selectivity requirement reduces the counter-majoritarian difficulty of Commission state-aid review because rent-seeking and selectivity are connected. The intuition is simple: Member State rules that result from rent-seeking by special interest groups are more likely to be selective than are rules with broad democratic support.[28] Because such selective rent-seeking rules usually lack broad democratic support, striking them down is not counter-majoritarian.[29] Tax rulings are an extreme example. Rather than laws, tax

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[26] *Cf.* John O. McGinnis & Mark L. Movsesian, *The World Trade Constitution*, 114 HARV. L. REV. 511 (2000) (arguing that by limiting itself to reviewing member state rules for protectionism, rather than expanding into substantive regulation, the WTO will encourage beneficial regulatory competition among members while avoiding questions about its legitimacy to regulate). *See also* discussion of the benefits and burdens of tax competition, *infra* Part III.A.1.

[27] *Cf.* ALEXANDER M BICKEL, THE LEAST DANGEROUS BRANCH: THE SUPREME COURT AND THE BAR OF POLITICS (1962) (discussing judicial review in U.S. context).

[28] Many have suggested that the need to protect important out-of-state interests that lack adequate political representation in the state makes the case for judicial intervention stronger. *See, e.g.,* South Carolina State Highway Dep't v. Barnwell Bros., 303 U.S. 177, 185 n.2 (1938) (Stone, J.). ("When the… burden [of regulation] falls principally upon those without the state, legislative action is not likely to be subjected to those political restraints which are normally exerted on legislation where it affects adversely some interests within the state.") Commentators have developed this view. *See, e.g.,* JOHN HART ELY, DEMOCRACY AND DISTRUST (1980); Julian N. Eule, *Laying the Dormant Commerce Clause to Rest*, 91 YALE L.J. 425 (1982) (arguing that such process concerns could be better handled under the Privileges and Immunities Clause than the Commerce Clause). Analogously, the case for Commission intervention under the state-aid rules is stronger when national political processes have been distorted. *Cf.* Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 952-4 (1992); (arguing that discriminatory taxes succeed because they benefit organized business taxpayers while diffusing harms across many taxpayers); Robert P. Inman & Daniel L. Rubinfeld, *Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism*, 75 TEX. L. REV. 1203 (1997) (making the same point with respect to regulation).

[29] The fact that a rule results from rent-seeking cannot by itself constitute grounds for the Commission to overturn it. *See*, *e.g.,* Bruce A. Ackerman, *Beyond Carolene Products*, 98 HARV. L. REV. 713 (1985); Terrance Sandalow, *The Distrust of Politics*, 56 N.Y.U. L. REV. 446 (1981); Lawrence H. Tribe, *The Puzzling Persistence of Process-Based Constitutional Theories*, 89 YALE L.J. 1063 (1980). But if such laws already violate the free-trade values embedded in the state-aid rules, that they also likely lack broad democratic support ameliorates majoritarian concerns about Commission

rulings are secret administrative pronouncements regarding the application of obscure and complicated corporate tax rules to a single taxpayer. Most voters have never even heard of such rulings and finding them to be state aid cannot be regarded as contrary to any voter's expressed preference.

Part IV uses doctrine to show that the Commission has fundamentally altered the selectivity requirement in recent cases by redefining it as deviation from a normative reference base, rather than a domestic law reference base. It explains that if the Court approves this interpretation on appeal, it will hand the unelected and inexpert Commission broad new policymaking powers.

Part V criticizes the Commission's recent approach. It argues that it forsakes the channeling effect of traditional selectivity analysis and is unnecessary to reach the results on the recent cases. The normative approach embroils the Commission in tax policy disputes that is has no expertise or legitimacy to resolve, while injecting uncertainty to a Europe already destabilized by Brexit and the financial crisis. Finally, the recent cases have jeopardized Commission and Member State credibility on the international stage at a time when global cooperation is needed to curb corporate tax avoidance.

As the status-quo approach, retaining the selectivity requirement may help dampen criticism of the EU in the political sphere, especially in non-EU member states that feel the spillover effects of the Commission's decisions.[30] State-aid recoveries are unlikely ever to be popular with non-member states, whose companies may pay large recoveries to EU states. Other states are, however, more likely to accept the results in state-aid cases when the Commission must prove selectivity as an element. As I explain in Part V, traditional selectivity analysis largely coincides with international consensus standards about what constitutes so-called harmful tax competition. Because many states have agreed to avoid harmful tax competition, an interpretation of state aid that coincides with the consensus standard should reduce controversy compared to an interpretation in which Commission defines as state aid Member State tax policies it disapproves of. For the same reason, retaining selectivity reduces the risk that the EU will become a relatively less attractive place to locate business because it has stricter tax rules than the rest of the world.

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review. *Cf.* McGinnis & Movsesian, *supra* note 26 (arguing that by suppressing the influence of "protectionist interest groups" the WTO promotes, rather than constrains, democracy).

[30] For example, the Irish recovery from Apple directly reduces the amount of U.S. tax Apple will ultimately pay because the United States will credit the Irish tax. *See* discussion *infra* Part V.D.3.

Now is an important moment for state aid. We are at the threshold of a new area of law and a new, potentially transformative, kind of tax anti-abuse enforcement. Judicial review of the cases against U.S. multinationals will set the standards for state-aid enforcement for the indefinite future.[31] The Member States agreed to be bound by the state-aid rules, knowing that those rules would constrain their sovereignty, including their tax sovereignty. The $14.5 billion question is *how much* do the state-aid rules constrain the states? The answer will distribute power between the EU central government and the individual Member States.

This Article is fundamentally conservative; it argues that when the Court of Justice considers the landmark appeals, it should confirm selectivity—that is, discrimination—as an essential element of state-aid analysis, thereby affirming the primacy of the Member States in setting tax policy. As this Article explains, confirming the selectivity requirement does not necessarily require vacating the Commission's recovery orders in the recent cases, because in each case, in addition to arguing that the Member State deviated from ideal tax policy, the Commission also used traditional selectivity analysis to argue that the Member States deviated from their own domestic law. Thus, the Court of Justice can affirm the results in the decisions while rejecting the Commission's new approach to state aid.

II. Balancing Free Trade and State Sovereignty

This Part describes the EU and state-aid law. It explains how the values underlying the prohibition of state aid—including free trade and market integration—are in tension with reserved Member State sovereignty.

A. EU Governance

Home to over 500 million people, the EU is the world's largest common market.[32] Established in the aftermath of World War II, the predecessor organization to the modern EU aimed to "make war

[31] Case T-760/15, Action for Annulment on Dec. 23, 2015, Netherlands v. Comm'n, 2016 O.J. (C 59) 50 [hereinafter Netherlands' *Starbucks* Appeal]; Case T-636/16, Action for Annulment on Sept 5, 2016, Starbucks and Starbucks Mfg. Emea v. Comm'n, 2016 O.J. (C 462) 25; Case T-755/15, Action for Annulment of Dec. 30, 2015, Luxembourg v. Comm'n, 2016 O.J. (C 59) 48 [hereinafter Luxembourg's *Fiat* Appeal]; Case T-759/15, Action for Annulment on Dec. 29, 2015, Fiat Chrysler Finance Europe v Comm'n, 2016 O.J. (C59) 49; Case T-778/16, Action for Annulment of Nov. 9, 2016, Ireland v. Comm'n, 2017 O.J. (C 38) 35 hereinafter [Ireland's *Apple* Appeal]; Case T-892/16, Action for Annulment of Dec. 19, 2016, Apple Sales Int'l & Apple Operations Europe v Comm'n, 2017 O.J. (C 53) 37.

[32] Eurostat, *The EU in the World* (2016), at 20.

unthinkable"[33] by integrating Europe's economies.[34] In addition to safeguarding peace, the union would enhance the welfare of Europeans by encouraging free trade and free movement of people, businesses, and capital.[35] From a group of six states in the 1950s, the EU has grown to a continent-wide, twenty-eight member union with political and social significance, and a central government that exercises increasingly important powers.[36] Its economy has grown larger than that of the United States.[37]

Two treaties govern the EU, the Treaty on European Union (TEU), and the Treaty on the Functioning of the European Union (TFEU).[38] The treaty framework provides four major institutions that are important for state aid. The Council holds primary legislative power.[39] When the Council decides tax matters, its membership consists of the finance minister of each Member State.[40] The Council can pass tax legislation only by unanimous vote, and only after consulting the directly elected

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[33] Schuman Declaration of 9 May 1950, reprinted in 13 BULL. EUR'N COMMUNITIES 14 (1980) [hereinafter Schuman Declaration].

[34] *See, e.g., Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Towards a Single Market Act for a Highly Competitive Social Market Economy*, COM (2010) 608 final, at 2, (Oct. 27, 2010) ("The construction of one big market is at the heart of the European project envisaged by the founding fathers."). While retaining the focus on economic integration, progressive amendments to the EU treaties have emphasized European solidarity and development of a European polity. MCCORMACK & OLSEN, THE EUROPEAN UNION: POLITICS AND POLICIES 194-213 (2013).

[35] TFEU, *supra* note 3, art. 45, (workers); *id*. art. 49 (establishment); *id*. art. 56 (services); *id*. art. 63 (capital).

[36] Twenty-seven without the United Kingdom.

[37] Eurostat, *The EU in the World* (2016), at 79 (listing share of world GDP in 2014 for the EU at 23.8% and the United States at 22.2%).

[38] Consolidated Version of the Treaty on the European Union, at 3, 2010 O.J. (C 83) 1, at 17 [hereinafter TEU]; TFEU, *supra* note 3.

[39] TFEU, *supra* note 3, art. 115. *See also id.* arts. 237 to 243 (describing Council).

[40] Europa, Economic and Financial Affairs Council Configuration (Ecofin), available at https://www.consilium.europa.eu/en/council-eu/configurations/ecofin/ (describing Ecofin). There are ten different configurations of the EU Council, whose membership for a given matter depends on the subject area, but always consists of one minister from each state. The EU Council is not to be confused with the European Council (which sets EU policy priorities and consists of the heads of state of the Member States, the Commission President, and the EU's top diplomat) or the Council of Europe, which is a pan-European, not just EU, organization. *See generally* MCCORMACK & OLSEN, *supra* note 34, at 118 to 135. Hereinafter "Council" will refer exclusively to the EU Council.

European Parliament.[41] The treaties also provide for two EU courts: the lower General Court and the Court of Justice, the highest EU court.[42] Finally, the Commission is an EU institution with no direct analog in the United States.[43] It holds both legislative and executive powers, and it has primary responsibility to enforce the prohibition on state aid.[44] Each Member State nominates a Commissioner, and Parliament accepts or rejects the slate.[45] Commission staff is likewise unelected.[46] The President of the Commission assigns to each Commissioner a particular portfolio of policy areas; the Commissioner for Competition is responsible for most state-aid enforcement.[47]

Taxes, and particularly the constraints EU law imposes on Member State tax systems, are a contentious issue in the EU.[48] With the glaring exception of Brexit, the Member States of the EU have built an "ever closer union" by reducing internal barriers to trade and free movement.[49] As they grew closer, the states conferred more powers on the EU. For example, whereas in earlier periods the EU could legislate only by the unanimous consent of the Member States, successive treaties have applied less stringent requirements to most regulatory areas.[50]

Tax stands in stark contrast to this centralizing trend. Despite many opportunities to move away from unanimity offered by successive treaty

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[41] TFEU, *supra* note 3, art. 115. *See also id*. arts. 223 to 234 (describing Parliament).

[42] TFEU, *supra* note 3, arts. 251 to 281 (describing courts).

[43] TFEU, *supra* note 3, arts. 244 to 250 (describing Commission).

[44] The Commission can initiate tax (and other) legislation. *See, e.g*., TFEU, *supra* note 3, art. 115. *See also* Council Reg. No. 2015/1589 of 13 July 2015, laying down detailed rules for the application of Article 108 of the TFEU, 2015 O.J. L 248/9 (codification), superseding Council Reg. No. 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, 1999 O.J. L 83/1 [hereinafter 2015 Regulation].

[45] MCCORMACK & OLSEN, *supra* note 34, at 97-117.

[46] MCCORMACK & OLSEN, *supra* note 34, at 97-117.

[47] TFEU, *supra* note 3, arts. 244 to 248.

[48] For prior commentary on the impact on Member State tax sovereignty of EU law, see generally Ruth Mason & Michael S. Knoll, *What is Tax Discrimination?*, 121 YALE L. J. 1014 (2012).

[49] TFEU, *supra* note 3, pmbl. (citing as one of the motivations for the Treaty the desire for "an ever closer union among the peoples of Europe").

[50] *See* EU, Qualified Majority Voting and the Ordinary Legislative Procedure (2015) available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM:ai0015 (describing the shift to qualified majority voting).

amendments, the Member States have retained unanimity for tax matters under Article 115.[51] Thus, taxes remain resolutely the domain of the Member States. The EU has no meaningful tax powers of its own, even though, as the financial crisis and euro crisis revealed, the choice to keep fiscal decisions at the state level has imposed severe costs.[52] The Court of Justice repeatedly has affirmed the Member States' income tax sovereignty, emphasizing their autonomy to define their tax bases,[53] set their tax rates,[54] and choose their international income-allocation rules.[55]

The recent cases pose the question of whether states conferred state aid by issuing taxpayers rulings that allowed them to pay too little tax. The relevant rulings involved the application of tax income-allocation rules. Income-allocation rules (or transfer-pricing rules) determine how much each state can tax of a multinational's global income, considering both the state's jurisdiction to tax and comity concerns, including whether other states will regard a particular rule as fair. Allocation rules differ from state to state, but states have reached consensus on one aspect of allocation—most use the so-called *arm's-length transfer-pricing method* to determine the income of multinationals, an issue that will be discussed later.

Each Member State has its own income tax system, and historically, the Member States have coordinated their income tax regimes through the OECD, not the EU. This could be changing; the 2008 financial crisis revealed the importance of fiscal coordination within the eurozone.[56] It also highlighted the need for international cooperation to address corporate tax avoidance.[57] In response to the crisis, in addition to working through the OECD on its landmark Base Erosion and Profits Shifting

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[51] TFEU, *supra* note 3, arts. 113, 115.

[52] *See generally* THE EUROPEAN UNION IN CRISIS (Dinan, et al., eds. 2017).

[53] *See, e.g.,* Case C-403/03, Schempp v. Finanzamt München V, ECLI:EU:C:2005:446 (holding nondiscriminatory "any disparities in treatment, . . . which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality").

[54] *See, e.g.,* Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, ECLI:EU:C:1998:221, paras. 34, 49, 53 (holding that divergences in the "level" of taxation among Member States are nondiscriminatory because EU law does not prescribe or harmonize member state tax rates).

[55] *Gilly*, para. 24 ("The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation . . . .").

[56] *See* Kenneth Dyson, *Playing for High Stakes: The Eurozone Crisis*, *in* THE EUROPEAN UNION IN CRISIS, *supra* note 52.

[57] *See* generally OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING (2013).

Project (BEPS), the Member States used EU institutions and EU legislative procedures to enact anti-abuse reforms for corporate taxation. The Commission's Directorate-General for Taxation (DG-Tax) took the leading policy role in those efforts, including by drafting legislative proposals that garnered the required unanimous endorsement of the Council.[58] The new legislation implements BEPS recommendations developed at the OECD.[59] The Commission also recently revived the Common Consolidated Corporate Tax Base (CCCTB), a legislative proposal for EU-wide harmonization of corporate tax bases.[60] The proposed harmonized base would be paired with a common formula for dividing taxable income of multinationals among the Member States in which they operate.[61] This legislation would transform EU corporate taxation, including by moving away from arm's-length to a different allocation rule, but its political fate is unclear.[62]

Although the Member States retain autonomy over their national tax systems, EU law constrains that autonomy in several ways. For example, the Court of Justice long has interpreted the TFEU's fundamental freedoms (the EU's analog to our dormant Commerce Clause[63]) to prohibit Member States from using their tax systems to discriminate against nonresidents or cross-border commerce.[64] While the fundamental freedoms limit *discriminatory taxes*, the state-aid rules, until

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[58] Council Directive 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, O.J. of L 193/1 [hereinafter ATAD I]; Council Directive amending Directive (EU) 2016/1164 regarding hybrid mismatches with third countries [hereinafter ATAD II].

[59] *See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Anti-Tax Avoidance Package: Next steps towards delivering effective taxation and greater tax transparency in the EU*, COM (2016) 23 final (Jan. 28, 2016) (Chapeau Communication).

[60] Proposal for a Council Directive for a Common Consolidated Corporate Tax Base (CCCTB), COM (2011) 121/4 [hereinafter 2011 CCCTB Proposal].

[61] 2011 CCCTB proposal, *supra* note 60, at 2.

[62] The proposal would implement formula apportionment in lieu of arm's-length, transfer pricing but the proposal requires unanimous support from the Member States to pass.

[63] *See* Mason & Knoll, *supra* note 48, at 1106-1115 (comparing U.S. and EU tax nondiscrimination principles).

[64] Mason & Knoll, *supra* note 48,at 1023-1033; Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186 (2006).

now, have limited *discriminatory subsidies*.[65] Thus, the state-aid rules likewise constrain Member State tax autonomy.

B. State Aid Values

It is hard to pin down what the state-aid rules forbid. Kelyn Bacon recently observed that state aid is "a mix of internal market policies, competition concerns, and considerations of economic efficiency and fiscal discipline."[66] None of these goals generates precise guidelines for directing Commission decision-making, and the Commission, General Court, and Court of Justice often take different positions on the same cases.[67] The Commission also regularly stakes out positions that vary from precedent or that go beyond its own published guidance.[68] Moreover, EU law expressly recognizes that the state-aid concept evolves with the common market, so that Member State policies previously judged compliant can become illegal aid due to further EU integration.[69] Thus, the state-aid rules have a reputation for "permanent expansion."[70]

The state-aid rules serve EU goals to reduce internal barriers to assembling capital, labor, and resources on a larger and more efficient scale.[71] Most observers would find unobjectionable the claim that the

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[65] In contrast with the EU, the U.S. Constitution has no express anti-state-subsidy provision. *See* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996) (arguing that the Supreme Court should interpret the dormant Commerce Clause to forbid state subsidies that entice inbound economic activity). For the differences and overlaps between the fundamental freedoms and state aid in taxation, see Wolfgang Schön, *State Aid in the Area of Taxation*, *in* EU STATE AIDS 397-401 (Hancher at al., eds. 2016). *See also* Peter J. Wattel, *Comparing Criteria: State Aid, Free Movement, Harmful Tax Competition and Market Distorting Disparities,* STATE AID LAW AND BUSINESS TAXATION (Richelle, et al., eds. 2016), at 59.

[66] KELYN BACON, EU LAW OF STATE AID 5 (2017). *See also Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee*, EU State Aid Modernization, COM (2012) 209 final (May 8, 2012) [hereinafter *State Aid Modernization Communication*] (same).

[67] MICHEAU, *supra* note 20, at 271-95.

[68] *See* discussion *infra* Part IV (describing Commission's variation from the domestic-law reference-base approach in the recent rulings cases).

[69] *See, e.g.,* Joined Cases C-182/03 and C-217/03, Kingdom of Belgium, Forum 187 ASBL, v. Comm'n, ECLI:EU:C:2005:266 (2006) (striking a tax regime that the Commission had previously approved as notified aid).

[70] Ryan Finley, *Commission's State Aid Powers Are Too Broad, German Report Says*, TAX NOTES INT'L (Nov. 27, 2017) (quoting the technical advisory board on state aid of the German Ministry of Finance).

[71] *See generally* COMITÉ INTERGOUVERNEMENTAL CRÉÉ PAR LA CONFÉRENCE DE MESSINE, RAPPORT DES CHEFS DE DÉLÉGATION AUX MINISTRES DES AFFAIRES

state-aid rules advance free trade goals—they curb sectoral subsidies, protectionism, retentionism, and policies that have effects equivalent to import or export subsidies.[72] Protectionism and similar policies undermine EU market integration; they distort private decisions along a number of margins relevant for the EU market—among them what and where to produce, where to invest, and what to invest in. Centralized control makes sense for such policies because they represent classic collective action problems—they harm the collective welfare of Europeans as both consumers and producers, though residents of a particular state may benefit from enacting them.[73] In addition to being inefficient in themselves, such provisions may inspire retaliation by other states, and they could be regarded as inconsistent with the very concept of union, particularly a political union like the EU.[74]

To resolve collective action problems that adversely impact EU market integration, the state-aid rules ban *certain kinds of selective advantages*, subsidies that discriminate on the bases of what this Article will call *suspect classifications*—sector, size, type, region, nationality, and engagement in cross-border economic activity. [75]

These classifications are suspect because states use them to enact the kinds of policies that state-aid forbids.[76] For example, protectionist policies generally discriminate on the basis of sector, nationality, or engagement in cross-border commerce—they favor domestic over foreign companies, products, or activities.[77] States also may saddle their own

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ETRANGÈRES, Doc. MAE 120 f/56 (1956) [hereinafter the Spaak Report]. *See id*. at 161-2 (criticizing protectionism).

[72] *State Aid Modernization Communication*, *supra* note 66, at para. 15 (describing state aid as a "policy aimed at limiting distortions of competition, preserving a level playing field and combating protectionism").

[73] See MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 9-21 (1965); *Cf.* Inman & Rubinfeld, *supra* note 28 (advocating central control of state policies that generate spillovers in a federal system).

[74] *Cf.* Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Claus*e, 84 MICH. L. REV. 1091, 1112–26 (1986) (describing in the dormant Commerce Clause context the harms of protectionism)

[75] Readers should be aware that the EU institutions do not employ suspect-classification terminology. I believe I am the first to place state-aid doctrine into a suspect classification framework. See Mason, *supra* note 20.

[76] *See* generally, Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131 (2001) (categorizing the varieties of discrimination against international commerce).

[77] Case 173/73, *Italian Republic v. Commission*, ECLI:EU:C:1974:71 (holding that Italy could not prefer domestic textile producers by granting them a payroll tax deduction that was unavailable to other sectors); Commission Decision of 21 December

residents with retentionist policies that discourage them from engaging in cross-border activities. Retentionist policies discriminate on the basis of location of economic activity—they burden companies' foreign activities more than their domestic activities with the goal of preventing productive factors from fleeing.[78] Import and export subsidies—and policies that have equivalent effects—restrain cross-border trade and investment; they discriminate on the basis of place of production, consumption, or investment. Thus, aid to foreign, but not domestic, companies may function equivalently to an import subsidy;[79] while aid to support foreign, but not domestic, capital investments may function equivalently to a capital export subsidy.[80] Size and whether the firm engages in cross-border or only domestic activities are themselves proxies for nationality.[81]

The same free trade arguments about the importance of preserving competition also justify the prohibition of individual aid, which is aid to a single enterprise (rather than a suspect class).[82]

By promoting level competition between private parties, the state-aid rules promote efficient production as well as efficient geographic allocation of productive factors across the EU.[83] State-aid control, and in

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1988 on aid granted by the Greek Government to the film industry for the production of Greek films, 1989 O.J. L 208/38 (invalidating aid distributed on the basis of nationality).

[78] Protectionist policies are retentionist, and vice versa. When states place special burdens on outsiders that do not apply to insiders, in addition to encouraging outsiders to stay out, they encourage insiders to stay in (where insiders derive a comparative advantage over outsiders who are subject to the special burden). Likewise, retentionist policies discourage outside participants from entering the domestic market because, by disfavoring insiders' economic activity outside the states, they give outsiders an advantage over insiders in competition that takes place outside the discriminating state. *See generally* Michael S. Knoll & Ruth Mason*, The Economic Foundation of the Dormant Commerce Clause* , 103 VA. L. REV. 309 (2017).

[79] *Cf.* Joined Cases C-182/03 and C-217/03, *Forum 187*, ECLI:EU:C:2006:416 (finding state aid where benefits were limited to multinationals that had a certain number of employees in Belgium).

[80] Joined Cases C 20/15 P and C 21/15 P, *World Duty Free Group*, ECLI:EU:C:2016:981 (finding that favorable tax rules for foreign stock ownership functioned as a capital export subsidy and were therefore state aid).

[81] *See* State Aid SA.44351(2016/C) (ex 2016/NN), Polish Tax on the Retail Sector (June 30, 2017) C(2017) 4449 final, at para. 47 (finding that a beneficial tax rate structure was "specifically designed to favour smaller retailers over larger ones . . . which also tend to be foreign owned"). If the Commission's views on size are correct, discrimination in favor of small companies would tend to be protectionist.

[82] The Commission is entitled to presume selectivity in individual aid cases. Case C-15/14 P, *Commission v. MOL,* ECLI:EU:C:2015:362, para. 60.

[83] For the classic account of efficiency concepts in international tax, see PEGGY BREWER MUSGRAVE, TAXATION OF FOREIGN INVESTMENT INCOME (1963). *See also*

particular the requirement that Member States notify and seek Commission approval before distributing aid, also offers national politicians cover for refusing to confer subsidies. It enables national politicians to credibly claim that their hands are tied, thereby shifting blame for unpopular decisions to the EU. Assigning supervisory authority over these subsidies to the Commission helps states avoid wasteful state spending because higher levels of government usually are more capable of handling policies or problems whose benefits and burdens spillover across jurisdictional lines.[84] Thus, the state-aid rules also instrumentally promote fiscal discipline.

Notwithstanding the importance of the values underlying state-aid control, EU law reserves a large margin of regulatory authority to the states, even when the exercise of that authority undermines efficiency.[85] Reservation of powers to the Member States is not only an important point of EU law; it is also good policy. Some degree of regulatory (and tax) competition is helpful to spur regulatory innovation and discipline governments.[86]

Thus, not all subsidies constitute appropriate targets for state-aid control. For example, income taxes could be said to subsidize firms with losses (by not taxing them), but that alone is not enough to make income taxation illegal aid.[87] Profitability is not a suspect class, nor should it be, since the state has legitimate reasons—reasons that have nothing to do with sectoral discrimination, protectionism, retentionism, or import or export subsidization—to distinguish between profitable and unprofitable companies. Thus, profitability is a poor proxy for the kinds of subsidies the state-aid rules are meant to prohibit. Similarly, while generally applicable low tax rates may cause inefficient locational distortions, and they could be conceived as tax subsidies, as long as they do not discriminate, they are not state aid.[88] The challenge for the Commission

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Mason & Knoll *supra* note 48, at 1051-1074 (competitive neutrality incidentally advances locational neutrality).

[84] *See, e.g.,* Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120 (1999) ("the provision of public services should be located at the lowest level of government encompassing, in a spatial sense, the relevant benefits and costs").

[85] 2016 NOTICE, *supra* note 22, at para. 156 ("Member States are free to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the various factors of production.").

[86] *See* discussion *infra* Part III.A.1.

[87] Joined Cases C-106/09 P and C-107/09 P, Gibraltar, ECLI:EU:C:2011:732, at para. 83.

[88] 2016 NOTICE, *supra* note 22, at paras. 132-34.

and EU courts, then, is to strike the proper balance between Member State autonomy and state-aid goals.[89]

C. The Traditional Conception of State Aid

The prohibition of state aid has appeared—nearly unaltered—in every EU treaty since the Treaty of Rome in 1958, and it applies to all areas, not just tax.[90] Article 107 TFEU provides that:

> Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by 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.[91]

The TFEU obliges the Commission to monitor state aid and ensure abolition of incompatible aid.[92] Due to its association with what Europeans call competition policy (what we call anti-trust), the European Commission's Directorate-General for Competition (DG-Comp) handles most state-aid enforcement, including tax state aid.

With some exceptions,[93] EU law requires Member States to seek Commission permission before enacting state aid. This is called "notified aid."[94] Notification provides the Commission an opportunity to determine whether the proposed measure is aid, and, if so, whether it fits within one of the many exceptions to the prohibition on state aid.[95] The recent tax

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[89] The Supreme Court faces a similar challenge under the dormant Commerce Clause to balance state autonomy against free trade interests. *See* Regan, *supra* note 74, at 1101-8 (describing types of judicial balancing under the dormant Commerce Clause).

[90] *See* MICHEAU, *supra* note 20, at 57 (detailing the stability of the language; alterations to the text merely changed the word "Community" to "Union").

[91] TFEU, *supra* note 3, art. 107(1).

[92] TFEU, *supra* note 3, art. 108.

[93] *See* Regulation 651/2014 declaring certain categories of aid compatible with the internal market in application of Article 107 and 108 of the Treaty, [2014] O.J. L187/1 (exempting from notification and control, among other categories of aid, certain aid for research and development, job training, environmental protection).

[94] *See, e.g.,* TFEU, *supra* note 3, arts. 107(2)-(3), (9).

[95] *See* TFEU, *supra* note 3, at 107(2) (covering aid to raise the standard of living in less developed areas, aid to promote "important projects of common European interest, and remedy a serious disturbance in the economy of a Member State"); *id*. art. 107(3)(e) (authorizing the Council to permit other forms of aid upon a proposal by the Commission); *id*., art. 106(2) (services of general economic interest, including natural monopolies); *id*., art. 107(3) (automatic and discretionary compatibility). *See also*

cases involve unnotified aid, provisions that the state enacted without prior Commission permission.

The Commission enjoys wide discretion in investigating unnotified aid,[96] and it has very broad compulsory powers—it can obtain information from any state and any firm, including from the putatively aided company and its competitors.[97] The challenged Member State, other Member States, and other interested parties (including competitors of the putatively favored enterprise) may participate in the investigation.[98] Sometimes complaints from competitors motivate those investigations.[99] Disproportionate investigation of U.S. multinationals in the recent tax cases led to charges from U.S. senators, members of Congress, and Treasury officials that the Commission discriminated against American companies.[100] The Commission denied bias.[101]

Adverse Commission decisions lead to modification or termination of the aid program, as well as monetary recovery of the subsidy from the aided enterprise, going back ten years.[102] The enterprise repays the aid to the state that originally granted it, a remedy designed to "put the enterprise in a position as if the aid had never been granted."[103] That is why a case against Ireland resulted in an order for Ireland to recover billions from Apple. The firm must pay the recovery amount regardless of the domestic

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Communication from the Commission on the application of the EU State aid rules to compensation granted for the provision of general economic interest [2012] O.J. C 8/4 (emphasizing market failures). *See generally* QUIGLEY, *supra* note 20, at 193-486 (analyzing aid for regions, small and mid-sized businesses, training and employment, research and development, the environment, rescue and restructuring, and financial crisis).

[96] *See* 2015 Regulation, *supra* note 44, art. 6. The Commission undertakes a three-step process consisting of (1) a confidential exchange of information with the state, (2) a preliminary assessment that leads to a so-called opening decision in which the Commission publicly reports whether it thinks there is aid, and (3) a final decision after a full investigation. *See* 2016 NOTICE, *supra* note 22, para. 128.

[97] 2015 Regulation, *supra* note 44, art. 12 (information injunction powers).

[98] 2015 Regulation, *supra* note 44, art. 1(h).

[99] *See* 2015 Regulation, *supra* note 44, art. 12.

[100] *See* discussion, *infra* Part V.D.3.

[101] Letter from Margrethe Vestager, European Commissioner for Competition, to Jacob J. Lew, U.S. Secretary of the Treasury (Feb. 29, 2016), at 2.

[102] The exact amount of recovery is typically determined by the aiding Member State under the guidance of the Commission. *See*, *e.g.*, *Apple*, *supra* note 5, at paras. 445-451 (describing how Ireland should calculate the recovery from Apple "to restore the position to the *status quo ante*").

[103] 2015 Regulation, *supra* note 44, art. 16.

statute of limitation for taxes.[104] The offending Member State keeps the recovery, which creates perverse incentives for states.[105]

The Commission bears the burden in state-aid cases to establish the following elements: (1) an advantage, (2) granted by a Member State, (3) to an undertaking. The advantage must be granted (4) selectively and it must (5) distort trade or competition in the internal market.[106] The Commission and EU courts often combine elements (1) and (4), referring to the combined requirement as "selective advantage" or simply "selectivity."[107] Once the Commission makes a case for state aid, the burden shifts to the Member State to show that the aid was proportional for achieving important government interests.[108]

The Commission and Court of Justice have long considered *tax savings* to constitute a relevant "advantage" for state-aid purposes.[109] By their nature, tax savings can only be conferred by Member States, so tax savings always satisfies the requirement that the aid be "granted by a Member State."[110] The interpretation of "undertaking" is very broad, and it includes all forms of business enterprise.[111]

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[104] 2015 Regulation, *supra* note 44, pmbl. para. 25. *Id.* art. 16.

[105] Michael J. Graetz, *Behind the European Raid on McDonald's*, WALL ST. J., Dec. 3, 2015 (noting that "governments may appeal the [Commission's] determinations in the European courts, but if they lose, they still win").

[106] *See* TFEU, *supra* note 3, art. 107. *See also* Joined Cases C-393/04 & C-41/05, Air Liquide Industries Belgium SA, ECLI:EU:C:2006:403, para. 28.

[107] *See* C-20/15 P and C-21/15 P, Commission v. World Duty Free Group, para. 7.

[108] Joined Cases C-106/09 P and C-107/09 P, Gibraltar, ECLI:EU:C:2011:732, para. 36 (noting tax state aid can be justified if it is consistent with the "nature or general scheme of the [tax] system"). The Commission listed the following as potential justifications for differentials in tax treatment, "the need to fight fraud or tax evasion, the need to take into account specific accounting requirements, administrative manageability, the principle of tax neutrality, the progressive nature of income tax and its redistributive purpose, the need to avoid double taxation, and the objective of optimising the recovery of fiscal debts." *See* 2016 NOTICE, *supra* note 22, at para. 139.

[109] *See, e.g.,* Case 173/73*, Italian Republic v. Commission,* 1974 E.C.R. 709 ECLI:EU:C:1974:71.

[110] *See, e.g.,* Commission Decision 2017/502 of Oct. 21, 2015 on State Aid Implemented by the Netherlands to Starbucks, 2017 O.J. (L 83) 38, at para. 226 [hereinafter *Starbucks*] (noting that the Court of Justice has long considered tax relief to be aid granted by a Member State).

[111] TFEU, *supra* note 3, art. 107(2)(a) (excluding consumer aid of a social character granted to individuals, provided it does not discriminate on the bases of product origin).

Controversially, the distortion-of-competition element is deemed satisfied in almost any case. [112] Many have called for the Commission and EU courts to give greater effect to the "distorts competition" and "affects trade" language of Article 107.[113] This language could be understood to limit state-aid enforcement to cases where a Member State confers a cognizable advantage to one or more enterprises over competitors. Such an interpretation might employ empirical evidence of the impact of the putative aid measure on comparative advantage. Such arguments, however, face an uphill battle against decades of precedent.

Thus, selectivity is "the decisive criterion" for establishing state aid in tax cases.[114] Selectivity derives from Article 107's requirement that, to be illegal, aid must favor "*certain* undertakings or the production of *certain* goods."[115] Traditionally, to be selective, a Member State rule had to discriminate—the state had to deviate from its own law for the benefit of some, but not all, similar taxpayers. But neither the term selectivity nor the domestic-law reference base appears in the text of Article 107. The text therefore does not unequivocally prevent measurement of aid against a normative, rather than a domestic law, reference base as in the recent cases.

D. The Domestic-Law Reference Base

Identifying advantages in tax cases poses a special challenge. In direct-aid cases, the Commission identifies advantages by asking whether independent investors would have made the same investment in the enterprise that the state did. For example, when the Commission evaluates whether a Member State made a loan to a firm at too low an interest rate or made an equity infusion on terms that were too favorable, the Commission compares the Member State's action to what an independent market economic operator (MEO) would have done in the same circumstances.[116] If the Member State struck a deal with a firm that was better than the firm could have negotiated with private parties, then the Member State conferred an advantage, and if it did so selectively, the Member State conferred state aid.

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[112] BACON, *supra* note 66, at 83-89 (noting criticism of commentators).

[113] *Id.*

[114] Case C-66/14, Finanzamt Linz v. Bundesfinanzgericht (opinion of Advocate General Kokott), ECLI:EU:C:2015:242, para. 114-5. The eleven advocates general represent no party to the case, and their function is to write advisory opinions in advance of the Court's decision. TFEU, *supra* note 3, art. 252.

[115] TFEU, *supra* note 3, art. 107(1) (emphasis added).

[116] 2016 NOTICE, *supra* note 22, at paras. 73-114 (describing the independent MEO test, benchmarking, and similar techniques for establishing state aid).

This technique provides no purchase in tax cases. There is no equivalent to the "independent market operator" in a tax case because only governments impose taxes. The Commission described tax state aid as "a reduction in the firm's tax burden in various ways" and the Commission cited as examples "special" deductions, exemptions, credits, deferral, or cancellation or rescheduling of tax debts.[117]

This definition will remind readers of tax-expenditure analysis. The Congressional Budget Act of 1974 requires estimation of tax expenditures as part of the President's annual budget, and the Act defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[118] The problem with tax expenditures, as has been understood for decades, however, is that they require agreement on a reference baseline from which they can be measured.[119] Professor Boris Bittker famously criticized the tax expenditure problem as laden with value judgments about ideal tax policy, from which deviations (tax expenditures) could be measured. [120]

Cognizant of the underlying controversy, the Treasury Department meticulously explains the choices it makes in estimating tax expenditures.[121] Treasury uses both normative and domestic-law reference bases for estimating tax expenditures, specifically indicating when it uses each kind of base.[122] This approach allows Treasury to cabin thorny

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[117] COMMISSION NOTICE ON THE APPLICATION OF THE STATE AID RULES TO MEASURES RELATING TO DIRECT BUSINESS TAXATION, 1998 O.J. C-384/03 (Dec. 10, 1998), para. 9 [hereinafter 1998 NOTICE].

[118] 2 U.S.C. § 622(3) (2006).

[119] For discussion of the difficulties of measuring forgone tax revenue, see STAFF OF J. COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS (Comm. Print 2008) [hereinafter JCT, TAX EXPENDITURES].

[120] Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 Nat'l Tax J. 244, 244, 260 (1969)("every man can create his own set of 'tax expenditures,' but it will be no more than his collection of disparities between the income tax law as it is, and as he thinks it ought to be"). *See also* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) (advocating estimation of tax expenditures from a normative base).

[121] In the most recent tax expenditure budget, Treasury spent 20 of 37 pages explaining how it estimated the tax expenditures, carefully explaining its baseline choices. *See* OFFICE OF MGMT & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE U.S. GOVERNMENT, FISCAL YEAR 2017 [hereinafter ANALYTICAL PERSPECTIVES].

[122] *See* ANALYTICAL PERSPECTIVES, *supra* note 121, at 1 ("the normal tax baseline and the reference tax law baseline—are used to identify and estimate tax

questions about ideal tax policies while still satisfying its obligation to convey information to lawmakers and voters about the distributive effects of tax policy choices.

In the U.S. domestic context, the consequence of labeling an item a tax expenditure is that its revenue cost has to be estimated and reported. In Europe, the stakes are considerably higher. If a state enacts an improper tax expenditure, the Commission may order the state to recover it from the taxpayer.

The Commission historically has taken a conservative approach by using a *domestic-law reference base*, rather than *normative reference base*, to identify state aid. Under the domestic-law-reference base, the Commission compares the state's tax treatment of the putatively favored undertaking(s) with the same state's treatment of similarly situated taxpayers under generally applicable domestic law.[123] The domestic-law-reference-base approach allows the Commission to identify "advantages" without having to pass judgment on the content of a Member State's generally applicable tax law. It thereby avoids entangling the Commission in fundamentally political tax policy questions that it has no authority (and no special expertise) to resolve. This Article argues that in recent cases the Commission has sought to jettison the domestic-law reference base in favor of a normative reference-base.

E. Tax Cases Under the Traditional Conception

In the past, the Commission has not considered non-discriminatory tax rules—such as uniformly low corporate tax rates—to be state-aid because they are not selective. But even discriminatory tax rules may not be state aid. Many tax laws discriminate for perfectly legitimate reasons.

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expenditures. For the most part, the two concepts coincide. However, items treated as tax expenditures under the normal tax baseline, but not the reference tax law baseline, are indicated by the designation "normal tax method'' in the tables. The revenue effects for these items are zero using the reference tax rules."). The Joint Committee measures tax expenditures from what it calls the "normal income tax law," by which it means a reference tax law baseline. See JOINT COMMITTEE ON TAXATION, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS, JCX-37-08, at 9 (May 12, 2008) ("Our determination of Tax Subsidies in most cases thus is made, not by reference to an alternative and hypothetical 'normal' tax chosen by the JCT Staff, but rather by reference to the face of the Internal Revenue Code itself (along with its legislative history and similar straightforward tools for identifying legislative intent)."). *See id.,* at 39 (referring to the baseline as a "identifiable general rule of the present tax law").

[123] 2016 NOTICE, *supra* note 22, at para. 128 (describing the domestic-law-reference-base approach and citing judicial doctrine employing it).

As noted above, income taxes discriminate between those with income and those without. Progressive income taxes discriminate on the basis of ability to pay. States often exclude charities, but not other organizations, from taxation. In the terminology of this paper, such bases are not suspect classes. These kinds of discrimination do nothing to disrupt market integration or private competition, and they are justified by legitimate government interests. As such, they are not illegal state aid.[124]

Both on appeal from an adverse Commission decision[125] or in response to a question referred by a national court,[126] the Court of Justice has had opportunities to consider whether several Member State tax provisions conferred state aid. The Court of Justice held that the following advantageous deviations from domestic law were not state aid, notwithstanding that they discriminated: a tax on companies limited to 15% of their profits,[127] an exemption for pass-through companies that was denied to corporations,[128] a procedural rule allowing companies with tax disputes that were more than ten years old to settle those disputes by paying five percent of the deficiency,[129] and an accelerated depreciation rule limited to certain tangible assets custom-built for leasing.[130]

In each case, the Member State deviated from domestic law in favor of a particular class of taxpayers. Each state discriminated—on the basis of profitability, legal form, age of tax dispute, or the intended use of tangible assets—but none discriminated on the basis of a suspect class. Although not every state would make the same policy choices as the ones reflected in the cases, none of the challenged policies involved covert

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[124] 1998 NOTICE, *supra* note 117, at para. 25.

[125] TFEU, *supra* note 3, art. 236 (providing procedure to annul a Commission decision).

[126] TFEU, *supra* note 3, art. 267 (providing procedure for national courts to refer to the Court of Justice for preliminary ruling questions of EU law).

[127] Joined Cases C-106/09 P and C-107/09 P, Gibraltar, ECLI:EU:C:2011:732, at paras. 77-84. The Court of Justice annulled the Commission's decision, which had concluded that the 15 percent caps would "appear self-evidently to grant an advantage to those companies that make no profit." Aid C 66/2002 (ex N 534/2002) — Gibraltar government corporation tax reform, 2002/C 300/02, para. 38.

[128] Joined Cases C-78/08 to C-80/08, Paint Graphos, ECLI:EU:C:2011:550, at para. 80 (holding Italy could exempt pass-throughs under a coherent scheme that included taxing the owners of pass-throughs).

[129] Italy had adopted the rule to comply with the speedy resolution rules of the European Human Rights Convention, *See* C-417/10, 3M Italia, ECLI:EU:C:2012:184, at para. 26.

[130] Case C-100/15 P, Netherlands Maritime Technology Association, ECLI:EU:C:2016:254 (affirming the Commission, which had decided not to pursue a formal state-aid case against Spain because its rule was not selective).

subsidies to darling enterprises or industries; none involved preferences to taxpayers of a certain sector, region, nationality, or size. Thus, regardless of whether the rules were good or bad tax policy, there was no need for the state-aid rules to intervene.

Contrast the following cases that involved illegal aid: social security tax exemptions available to the textile industry, but not other industries;[131] tax incentives available for investment in former East Germany, but not other parts of Germany;[132] energy-conservation tax credits available to manufacturers, but not service-providers;[133] special deductions for foreign branch start-up and promotional costs when those costs were incurred by steel exporters, but not when incurred by other enterprises;[134] reduced tax rates available to banks engaged in consolidating mergers, but not companies in other sectors;[135] exemption from a tax on "motive force" available to the natural gas industry, but not other industries;[136] special income-calculation rules available to coordination centers, but not other kinds of companies;[137] exemption from a tax on stopovers available to local, but not foreign, vessel owners;[138] and

[131] *See*, *e.g.,* Case 173/73, Italian Republic v. Commission, ECLI:EU:C:1974:71 (emphasizing, in finding illegal aid, that Italy hoped to enable Italian textile firms to compete more effectively with firms from other Member States).

[132] Case C-156/98, Germany v. Commission, ECLI:EU:C:2000:467 (holding that the aid did not satisfy the division-of-Germany exception for state aid because that exception only applied to compensate for disadvantages that stemmed from the physical (not economic) division of Germany).

[133] C-143/99, Adria-Wien, ECLI:EU:C:2001:598,at para 54 (noting the provision was "intended to preserve the competitiveness of the [Austrian] manufacturing sector, in particular within the Community").

[134] Case C-501/00, Spain v. Commission, ECLI:EU:C:2004:438, at para. 120-5 (holding that the aid measure operated as an export subsidy even though it was not linked directly to exports).

[135] Case C-148/04, Unicredito Italiano, ECLI:EU:C:2005:774, at para. 51 (emphasizing that Italy's motivation for the tax rate reduction was to help Italian banks compete with foreign banks).

[136] Joined Cases C-393/04 & C-41/05, Air Liquide Industries Belgium SA, ECLI:EU:C:2006:403 (finding illegal sectoral aid due to exclusion of other enterprises that used motive force to propel other industrial and medical gases).

[137] Joined Cases C-182/03 and C-217/03, Forum 187 ASBL, ECLI:EU:C:2006:416, at para 6 ("Only certain preparatory, auxiliary and centralisation activities are authorised, and undertakings in the financial sector are excluded from the regime").

[138] Case C 169/08, Presidente del Consiglio dei Ministri, ECLI:EU:C:2009:709, at para. 66 (holding the Sardinian rule discriminated against foreign service-providers).

favorable goodwill depreciation deductions available for purchases of foreign, but not domestic, stock.[139]

In each case, the Court of Justice held that the challenged regime privileged certain taxpayers over similarly situated private-market competitors; they all involved discrimination. But unlike the last set of cases, these cases favored members of suspect classes selected on the basis of sector, region, size, nationality, or whether the enterprise engaged in cross-border economic activities (such as exporting). Each case employed the domestic-law-reference-base approach; the Commission and Court of Justice established state aid by comparing the state's treatment of the favored taxpayers to that same state's treatment of taxpayers outside the privileged class (i.e., taxpayers in other sectors, regions, or of different nationalities, and so on). Thus, until recently, tax cases have consistently used the domestic-law reference base, and the main determinant of whether a regime constituted illegal aid has been whether it unjustifiably favored a particular company or a suspect class.

III. The Role of Selectivity

In Part IV, I will show that the Commission has sought to alter the traditional approach to selectivity analysis. Under the Commission's new approach, rather than determining whether the Member State deviated *from its own law* in favor of a particular company or a suspect class, the Commission asks whether the Member State deviated *from the Commission's view of ideal tax policy* in favor of a particular company or a suspect class. Before considering the Commission's reinvention of selectivity, however, this Part draws on economic and political-process arguments to explain the unappreciated role selectivity plays in balancing market-integration goals against the benefits of tax and regulatory competition that arise from Member State autonomy.

First, I argue that the traditional selectivity requirement encourages states to internalize more of the costs of their competitive tax and regulatory policies than they would if they could discriminate. At the same time, however, the selectivity requirement does not place any other content restrictions on Member State tax or regulatory policies, leaving states free to adopt different policies from each other. Thus, the traditional selectivity requirement secures for the EU more of the benefits of tax (and regulatory) competition than would the Commission's new approach.

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[139] Joined Cases C 20/15 P and C 21/15 P, World Duty Free Group, ECLI:EU:C:2016:981, at para. 104 (noting that "favouring exports of capital could give rise to distortions in the internal market in the same way as the act of specifically favouring exports of goods").

Second, I argue that because it focuses Commission enforcement on discriminatory provisions that are unlikely to garner widespread voter support, the selectivity requirement helps ameliorate democratic concerns about the review of national policies by the unelected Commission.

While I couch the arguments in this Part in terms of taxes, they apply generally to all forms of state aid.

A. Fiscal Federalism

This Subpart describes the benefits and burdens of unbridled state tax competition, and it establishes the need for centralized control of Member State tax competition. It then explains how the selectivity requirement strikes an appropriate, if imperfect, balance between the risks and rewards of tax competition by requiring states to offer attractive tax regimes on a nondiscriminatory basis. The nondiscrimination requirement discourages competitive tax by forcing states to internalize more of the costs of those regimes into their own economies.

1. Benefits and Burdens of Regulatory Competition

The principal problem raised by tax competition is the possibility that it will lead to a destructive race to the bottom in which states competitively lower tax burdens until they either cannot adequately fund public goods or must shift taxes to less mobile factors such as labor or to land.[140] But the only way to completely eliminate tax (and spending and regulatory) competition in the EU would be to harmonize taxes (and spending and regulation).

Such harmonization would, however, come at the cost of tax diversity.[141] While tax diversity undoubtedly distorts business decisions, it also confers benefits.[142] Economists argue that tax competition promotes welfare by constraining self-interested politicians who, without regard to voter preferences, seek to maximize tax revenue and the size of the public

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[140] A variety of empirical studies arrive at mixed conclusions on the impact of tax competition. For literature reviews, see John D. Wilson & David E. Wildasin, *Capital Tax Competition: Bane or Boon*, 88 J. PUB. ECON. 1065 (2004); Michael Keen & Kai A. Konrad, *The Theory of International Tax Competition and Coordination*, *in* HANDBOOK OF PUBLIC ECONOMICS (2013); TSILLY DAGAN, INTERNATIONAL TAX POLICY BETWEEN COMPETITION AND COOPERATION 23-31, 121-130 (2017).

[141] *See generally* Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 3 (1995) (touting benefits of market-preserving federalism).

[142] *Cf.* McGinnis & Movsesian, *supra* note 26 (arguing in the trade context that regulatory competition is salutary, at least when the trade regime prevents the flourishing of protectionist legislation).

sector.[143] Under this view, residents "tame Leviathan" by exiting—or threatening to exit—jurisdictions or by politically punishing lawmakers for imposing higher taxes than those applicable in neighboring jurisdictions.[144]

Other proponents of diversity in taxation would argue that cross-border differences allow policymakers to discover more efficient and equitable methods of taxation. Thus, states can learn from the experiences of other states, and competition drives them to innovate in a race to the top. Finally, tax diversity can help reveal hidden preferences as taxpayers move to the jurisdiction that offers their preferred combination of public goods and taxes.[145] Such information would be lost in a harmonized tax regime. In short, many of the benefits (as well as burdens[146]) claimed for regulatory competition also apply to tax competition.

Citing some of these reasons, a report by the European Parliament observed:

> tax competition is not at odds with the completion of the internal market, which does not entail a total levelling-out of competitive conditions in each country and certainly not those relating to taxation; [taxation] is an issue which is internal to each country, but does demand the intensified removal of discrimination, double taxation and administrative barriers.[147]

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[143] *See* GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION 186 (1980) (arguing that despite the spillovers between different units in a federal system, tax competition is "an objective to be sought in its own right" because of its constraining effect on tax rates and revenue-seeking politicians).

[144] Jeremy Edwards & Michael Keen, *Tax Competition and Leviathan*, 40 Eur. Econ. Rev. 113 (1996). *See also* Marius Brulhart & Mario Jametti, *Does Tax Competition Tame the Leviathan*, Working Paper (2016), http://www.hec.unil.ch/mbrulhar/papers/leviathan.pdf (using empirical evidence from the Swiss federal system to conclude that tax competition moderates levels of taxation).

[145] Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419–20 (1956) (employing a theoretical model).

[146] For burdens of regulatory competition, see, for example, Rubinfeld & Inman, *supra* note 28, at 1245-6 (giving reasons why regulatory competition might not work like private competition); Michael A. Livermore, *The Perils of Experimentation*, 126 YALE L.J. 636 (2017) (arguing that experimentation can lead to the production of information, particularly political information, that can be harnessed by rent-seekers).

[147] European Parliament, Report on the Commission communication on tax policy in the European Union—Priorities for the years ahead, A5-0048/2002, at 6. *Id.* at 7

The Member States apparently lack political will for widespread income tax harmonization,[148] and the Commission lacks both justification and authority to use the state-aid rules to effectuate tax harmonization.[149]

2. Need for Centralized Control

Centralized control of tax competition through the state-aid rules makes sense. First, powerful national business interests make it unlikely that any state will adopt unilateral defensive measures against other states engaged in tax competition.[150] Application of unilateral defensive measures also may alienate other states. And while Member States can avoid adopting their own costly subsidies, voters may impose stiff penalties on elected officials if departing businesses cite taxes as a reason for relocating job-creating activities abroad. Compared to Member State officials, unelected Commission bureaucrats are relatively insulated politically, allowing them to better weather such criticism. Controlling tax competition at the EU level also may make retaliation less likely because aggrieved states whose competitive tax gambits are struck down by the Commission cannot focus their displeasure on any one state.

Second, no state can defect from mandatory EU-wide state aid control. In the absence of retaliation or third-party enforcement, it makes sense for small states to uses tax incentives aggressively to siphon economic activity (or taxable income) from their larger neighbors.[151] Small states cannot compete effectively for location of real economic activity because they have little to offer large multinationals in terms of labor and other resources. This phenomenon may have led Luxembourg (and other small EU states) to arrange secret deals with taxpayers to shift taxable income from larger EU states to Luxembourg where it would be—unbeknownst to the larger states—subject to tax rates below

("tax competition may in itself be an effective instrument for reducing a high level of taxation").

[148] There is no consensus on harmonization. *See, e.g.,* EU Parliament, Report on the Commission's Communication on Priorities for the Years Ahead, final A5-0048/2002 (Feb. 22, 2002), at 9 [hereinafter 2002 EU Parliament Report] ("the harmonisation of [company tax] makes no sense, even in the form of the introduction of a minimum level of tax").

[149] *See* discussion *infra* Part V.C.

[150] The OECD countries envisioned a variety of defensive, or "counter-acting" measures, including credit limitations. *See* OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998) 37-59 [hereinafter 1998 OECD REPORT].

[151] *See* Keen & Konrad, *supra* note 140, at 310-311 (describing the "concept of commercialization of a country's sovereignty").

Luxembourg's normal burden.[152] The problem of small-state holdouts also makes it unlikely that tax harmonization (or other legislative measures to counter harmful tax competition) will garner the required unanimous vote to harmonize taxes of reduce tax competition at the EU level. The state-aid rules resolve this holdout problem, bringing competitive tax practices under the control of the Commission for the benefit of the EU as a whole.[153] Hence, it comes as no surprise that the finance ministers of Germany and France initially praised the Commission's actions to investigate secret rulings.[154]

Third, the state-aid rules provide something that intergovernmental soft-law projects to curb tax competition (including BEPS) lack—mandatory penalties.[155] For these reasons, controlling tax competition at the EU level is likely to be more effective than unilateral Member State preventative measures, EU legislation, or global soft-law projects.

3. Internalization

Once we recognize the need for centralized control of competitive tax regimes, the challenge becomes distinguishing harmful tax competition from beneficial tax diversity. Several transnational efforts have been made to identify harmful tax practices engaged in by countries that otherwise are not tax havens. The EU and OECD undertook separate efforts in the late 1990s.[156] Recognizing the benefits of tax diversity and

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[152] *See generally* Omri Marian, *The State Administration of International Tax Avoidance,* 7 HARV. BUS. L. REV. 1 (2017) (analyzing rulings released as part of LuxLeaks).

[153] *Cf.* WALLACE E. OATES, FISCAL FEDERALISM (1972) (arguing that "the provision of public services should be located at the lowest level of government encompassing, in a spatial sense, the relevant benefits and costs); C Robert D. Cooter & Neil S. Siegel, *Collective Action Federalism: A General Theory of Article I, Section 8*, 63 STAN. L. REV. 115, 137 (2010) (arguing "for allocating political power in a federal system" according to "the *internalization principle: assign power to the smallest unit of government that internalizes the effects of its exercise*") (emphasis in original).

[154] Lilian V. Faulhaber, *The Trouble with Tax Competition: From Practice to Theory* (forthcoming, on file with author), at [27]. Germany seems to have moderated its enthusiastic reception due to the potential impact on state tax autonomy of the theories articulated by the Commission in the recent decisions. See OPINION OF THE SCIENTIFIC ADVISORY BOARD OF THE GERMAN FEDERAL MINISTRY OF FINANCE, TAX BENEFITS AND EU AID SUPERVISION (2017), at 2 [hereinafter GERMAN FINANCE MINISTRY REPORT].

[155] The soft-law projects have relied mostly on threats of shaming and retaliation.

[156] *See* Resolution of the Council and the Representatives of the Governments of the Member States, Meeting within the Council, of 1 December 1997 on a Code of Conduct for Business Taxation, 1998 O.J. (C 2) 2, 2 [hereinafter Code of Conduct] (resolution among EU Member States to avoid harmful tax practices for); 1998 OECD

the political impossibility of tax harmonization, the EU and the OECD countries adopted definitions of harmful tax competition that allowed tax rates, bases, and allocation methods to vary.[157] Because they wanted to avoid dictating the content of states' tax bases, the countries defined harmful tax competition in part by reference to deviations from a domestic-law reference base.[158] Thus, discrimination has long been considered an indicator of harmful tax practices.

There were good reasons for states to conclude that discrimination was a reliable indicator of harmful tax policies. States discriminate to target tax incentives and reduce the revenue costs of offering those incentives. For example, to lure business or taxable income from abroad, a state may limit beneficial regimes to foreign businesses.[159] Or a state that hopes to encourage outbound capital investment may offer residents incentives that apply to foreign, but not domestic, stock.[160] In contrast, if the Member State provided tax benefits for all stock investments foreign and domestic, the subsidy would be costlier and less targeted. Thus, discrimination allows states to externalize the costs of competitive tax policies to other states. The incentivizing state receives new inbound investment or business without having to reduce the tax it collects on pre-

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REPORT, *supra* note 150 (defining harmful tax practices). *See generally* Faulhaber, *supra* note 154 (examining evidence from international agreements to determine what countries regard as harmful tax competition).

[157] *See generally* Code of Conduct, *supra* note 158; 1998 OECD REPORT, *supra* note 150.

[158] The Code refers to "tax measures which provide for a significantly lower effective level of taxation… than those levels which generally apply in the Member State in question." Code of Conduct, *supra* note 158, at 1. The 1998 OECD Report referred to low absolute effective tax rates, rather than effective tax rates that were low compared to ordinary domestic law. 1998 OECD REPORT, *supra* note 150, at 26. But the OECD's other factors for identifying harmful regimes, including ring-fencing, highlighted the importance of discrimination to the OECD's original approach. A regime is ring-fenced when it is only available to nonresidents or the domestic economy is otherwise insulated from its affects. *See id*. The modern OECD effort to combat harmful tax practices makes clear that deviations from a domestic-law reference base are what matters for purposes of identifying harmful regimes. OECD, COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE: ACTION 5: 2015 FINAL REPORT (2015), at 19 [hereinafter OECD, FINAL ACTION 5 REPORT] ("the key point is that the regime must be preferential in comparison with the general principles of taxation in the relevant country").

[159] *See, e.g.,* Commission Decision on the Excess Profit Exemption State Aid Scheme implemented by Belgium COMP/SA.37667 (Jan. 11, 2016) [hereinafter *Belgian Excess Profits*] (exempting so-called excess profits for multinational, but not domestic, groups).

[160] *See, e.g.,* Joined Cases C 20/15 P and C 21/15 P, World Duty Free Group, ECLI:EU:C:2016:981 (holding Spain violated the state aid rules when it limited tax preferences to purchases of foreign, but not domestic, stock).

existing domestic investors or businesses.[161] This new investment comes from other states, which will, in turn, feel pressure to offer like incentives.

In this context, we can understand selectivity as an internalization requirement. To avoid meeting the selectivity element of state aid, Member States must avoid discrimination. Avoiding discrimination forces Member States to internalize more of the costs of attractive tax regimes, which, in turn, makes states less likely to adopt them. For example, compare two policies. A state with a 30 percent corporate tax rate might make *only multinationals* eligible for a 10 percent corporate tax rate, while continuing to tax domestic companies at 30 percent. Such a policy would lure multinationals from neighboring countries while keeping the costs to the state—in terms of tax revenue losses—low. A different version of the policy would tax everyone—both multinationals and domestic companies—at 10 percent. This regime would still attract multinationals, but it costs more. Under the traditional to selectivity approach, the first policy is selective, but the second is not.

By raising the costs of competitive tax and regulatory policies, the selectivity requirement discourages them. At the same time, however, the traditional approach does not prevent states from enacting attractive, but nondiscriminatory, regimes, such as the across-the-board 10 percent corporate tax rate. In this way, the selectivity requirement strikes an appropriate balance between free trade goals on the one hand and Member State autonomy and regulatory diversity on the other.

This point bears repeating, and it is not limited to tax subsidies. The selectivity requirement ensures that a Member State can enact competitive tax (or regulatory) practices—even if those policies have adverse cross-border effects—*provided the state is willing to internalize the impact of that rule in its domestic econom*y. The selectivity requirement thereby limits the scope of state aid. For example, the selectivity requirement ensures that, as economists advise, small states that have trouble competing with large ones for tax base and location of productive factors can adopt generally applicable tax incentives, including low tax rates, to improve their relative position.[162] Similarly, states that keep their tax rates low by governing efficiently will have comparative advantages in the competition for productive factors, as will states whose voters prefer smaller public sectors.

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[161] 1998 OECD REPORT, *supra* note 150 (criticizing such discrimination because it "effectively protects the sponsoring country from the harmful effects of its own incentive regime").

[162] *See* Keen & Konrad, *supra* note 140, at 273-4 (reviewing tax competition literature).

In this way, the traditional selectivity-based conception of state aid allows a state to implement an attractive tax base (or regulation) as long as it's willing to pay for it. But states cannot have their cake and eat it, too. They cannot have one rule for Apple and another for everyone else. Nor can they have one rule for multinationals and another, less favorable, rule for domestic companies.

The Commission therefore can attack bespoke or sweetheart rulings in which Member States promise tax treatment more favorable than that available under domestic law—it can do this under the traditional conception of state aid as preventing selective deviations from domestic law. Finally, and again without stretching state-aid beyond its traditional interpretation, the Commission can attack other discriminatory tax policies that treat multinational taxpayers better than domestic taxpayers.

B. State Aid and Democracy

So far, I have analyzed the state-aid rules as a response by central government to interjurisdictional competition. On this fiscal federalism account, state-aid control limits certain kinds of destructive state competition. In contrast, this Subpart explains the role of selectivity as part of a political account of state aid. It presents the argument by analogy to judicial review that because the Commission's state-aid powers are counter-majoritarian, they should be construed narrowly. It then explains how the selectivity requirement helps focus state-aid enforcement efforts on Member State provisions that, because they are discriminatory, are unlikely to enjoy broad democratic support. Thus, selectivity tempers majoritarian concerns about state aid.

1. Counter-Majoritarian State-Aid Review

Within an overall EU governance system said to lack democratic legitimacy,[163] state-aid control is fundamentally counter-majoritarian because it gives the unelected Commission the power, subject to judicial review, to strike down national laws passed under national democratic processes.[164] Thus, state-aid control trades economic efficiency for political accountability.[165] Legitimacy concerns generally weigh in favor of retaining, rather than jettisoning, doctrinal requirements like selectivity that make it harder for the Commission to strike Member State laws.

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[163] MCCORMACK & OLSEN, *supra* note 34, at 212. Only the EU Parliament is directly elected, and Parliament's power is limited compared to typical national parliaments. *Id*.

[164] *Cf.* BICKEL, *supra* note 27 (discussing judicial review).

[165] *Cf.* Inman & Rubinfeld, *supra* note 28, at 1229 (describing an "inevitable tension between political participation and economic efficiency" in federalism).

Some tax policies are uncontroversial even among non-experts, including the notion that taxpayers should be able to deduct the costs of earning taxable income. Other policies enjoy widespread support among experts and policymakers. For example, the success of the WTO reflects consensus that protectionism retards global productivity.[166] On such matters, views of Commission staff are unlikely to diverge from those of national voters and policymakers. But other issues, including many corporate tax base questions, enjoy no such consensus. Views differ about the advisability of many regimes that the Commission has scrutinized under the state-aid rules, including pass-through taxation,[167] income tax caps,[168] payroll and property taxes,[169] the scope of corporate tax anti-abuse rules,[170] and the exemption of certain kinds of passive income.[171]

Consider the arm's-length method. Notwithstanding the success of the OECD's Transfer Pricing Guidelines at standardizing application of the arm's-length method, states take diverging views on how to apply those standards, and some large economies reject them.[172] Moreover, the Commission has a major reform proposal that would move away from using arm's length in favor of formulary apportionment, a competing allocation paradigm.[173] Such policy debates, which lack obviously correct

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[166] The WTO has 164 members. WTO, Members and Observers, available at https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

[167] Joined Cases C-78/08 to C-80/08, Paint Graphos, ECLI:EU:C:2011:550, para. 80. (holding Italy could exempt pass-throughs under a coherent scheme that included taxing the owners of pass-throughs).

[168] Joined Cases C-106/09 P and C-107/09 P, Gibraltar, ECLI:EU:C:2011:732 (vacating the Commission's decision that income tax caps discriminated in favor of companies with no profits).

[169] *Id.* (confirming the Commission's decision that payroll and property taxes discriminated in favor of offshore companies).

[170] Commission Decision Initiating the Formal Investigation in SA.44896 (2017/C ex 2017/NN) – United Kingdom CFC Group Financing Exemption, O.J. 2017/C 400/03 (Oct. 26, 2017) (positing that Britain's corporate-tax anti-abuse rule was too narrow and therefore provided illegal aid).

[171] State Aid SA.34914 (2013/C) – (ex 2013/NN) – United Kingdom Gibraltar Corporate Tax Regime, C(2013) 6654 final (Oct. 16, 2013) (concluding that Gibraltar could not exempt passive investment from the income of all taxpayers because such an exemption would favor financial institutions that disproportionately earned such income).

[172] *See*, *e.g.*, Sony Kassam & Alex Parker, *Brazil's Tax System Is Barrier to OECD Membership*, BLOOMBERG (Aug. 30, 2017) (noting Brazil's "use of transfer pricing methods that differ from the arm's-length standard").

[173] *See* 2011 CCCTB Proposal, *supra* note 60.

answers, are decided in the political sphere via democratic processes designed to capture voters' moral and political preferences.[174]

One might respond that the Commission's lack of democratic accountability is no special cause for concern because the Commission's role in enforcing state aid is negative, rather than positive. Under the traditional interpretation, the Commission can strike a Member State tax regime as prohibited aid, but it has no authority to substitute a new policy in place of the old. But, as the next Part explains, the Commission's recent move to substitute a normative reference base for the traditional domestic-law reference base upsets that dynamic. If the Commission has the power not only to strike selective subsidies, but also to articulate ideal tax rules, conformity with which represents the *only* defense from a state-aid claim, then policy control has moved from the Member States to the Commission. Loss of democratic accountability attends this move.

Of course, the idea that the Commission's lack of a democratic mandate should constrain its enforcement power has limits, too. A rank preference for tax policy produced by national democratic processes would counsel in favor of no state-aid control at all. The domestic-law reference-base approach may not be the perfect answer to this conundrum, but as compared to the normative-reference-base approach, it seems to err on the right side of both caution and Article 115, which reserves tax powers to the Member States.

2. Democracy-Enhancing State-Aid Review

One response to the counter-majoritarian objection to state-aid enforcement might be that Member State policies that constitute state aid lack a clear democratic mandate. For example, all the recent cases involved secret rulings issued by Member State administrators that applied obscure and complex corporate income allocation rules that most voters had never even heard of, much less formed opinions about. Not only do such rulings lack explicit democratic support, but voters did not even know about them.[175]

The idea that Member State policies that qualify as state aid lack broad democratic support therefore may help ameliorate state-aid's

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[174] *See generally* John R. Brooks, *The Definitions of Income*, 71 TAX L. REV ___ (2018). *Cf.* McGinnis & Movsesian, *supra* note 26, at 529 (compared to supranational institutions, "national institutions, which are more accountable to the average citizens, are more likely to reflect the tastes, traditions, and economic realities of the people whom they most affect").

[175] Although Member States agreed in 2016 to exchange rulings among themselves, such rulings will not be publicly available. OECD, FINAL ACTION 5 REPORT, *supra* note 158.

counter-majoritarian difficulty. If we make the realistic assumption that discriminatory Member State policies are less likely than nondiscriminatory policies to enjoy broad democratic support, then the selectivity requirement makes it more likely that the Commission will strike provisions that lack broad democratic support. In other words, sometimes undemocratic central institutions can cure defects in state democratic processes.[176]

State governments face significant pressures to subsidize inbound investment, national champions, and failing companies that provide jobs to voters, even in the face of evidence that such subsidies do not work.[177] For example, in the wake of the Apple investigation, a group of U.S. business leaders wrote to the Dutch government, urging it to continue its rulings practice.[178] The business leaders warned that changes to Dutch tax ruling practice could jeopardize the U.S. investment into the Netherlands. The group noted that U.S. companies have created 450,000 jobs in the Netherlands and that U.S. companies represented almost five percent of Dutch GDP.[179] Similar business groups wrote to other EU and Member State leaders.[180] Such pressures can be hard for national lawmakers to resist.

Consider also the example of sweetheart tax rulings in which a Member State agrees to deviate from domestic law in favor of a particular multinational. Sweetheart rulings transfer state resources from all other taxpayers to a particular multinational. They create diffuse harms, but concentrated benefits. [181] Because they result from rent-seeking behavior, striking them presents few democratic concerns. Rent-seeking and

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[176] *Cf.* ELY, *supra* note 28 (arguing that judicial review can reinforce democracy by protecting the interests of political minorities).

[177] Enrich, *supra* note 65, at 393-7 (reviewing empirical evidence of business tax incentives). Even if such subsidies do not work, politicians can score points (or avoid blame) by appearing to do something to help job-creators because success is visible, while the burdens of failure are widely diffused. *Id*. The state-aid rules allow some aid to companies in distress, under the Commission's guidelines. *See* QUIGLEY, *supra* note 20, at 403-427 (discussing rescue and restructuring aid). The Commission also authorized aid during the financial crisis. *See id.* at 463-489.

[178] Tax Directors Letter to Dutch Prime Minister, *supra* note ___, at 1.

[179] *Id.*

[180] Letter from Business Roundtable President John Engler to German Chancellor Angela Merkel (Sept. 15, 2016) [hereinafter Business Roundtable Letter to Merkel (warning that the state-aid investigations would disrupt trade and investment in Europe). *See id.* at 1 (noting that Business Roundtable CEO members lead U.S. companies with $7 trillion in annual revenues and nearly 16 million employees [that]… invest billions of euros and employ millions in the [EU]").

[181] *See generally* OLSON, *supra* note 73.

selectivity are connected because effectuating a transfer from everyone to a single taxpayer or small group of taxpayers will often be accomplished through discriminatory—that is, selective—national laws, policies, or administrative actions.[182] Of course, the correspondence between selectivity and democratically defective Member State laws is, like the correspondence between selectivity and harmful competition, imperfect. Still, even if we think that the Commission should not generally be in the business of trying to fix policies that result from defects in national democratic processes, if the challenged rule otherwise impermissibly interferes with the EU market, that it is also selective makes it more likely that it lacks broad democratic support. Selective provisions generally will lack democratic support because they discriminate in the conferral of benefits—often limiting benefits to a relatively small group of rent-seekers.

Commission officials are unelected, which insulates them from voter and lobby pressure, and most staff are civil servants, not politicians.[183] Commission staff represent the interests of the EU, not those of any particular Member State.[184] Thus, compared to national governments that confer state aid, the Commission is less subject to capture and myopia. In the case of state-aid enforcement, the Commission's lack of political accountability is an asset because it helps the Commission counteract wasteful rent-seeking at the state level.

Kicking subsidy decisions to the central government may not always have salutary effects. On the one hand, threats of exit by businesses that generate irrational state responses may dissipate at the EU level.[185] On the other hand, if the interests of lobbies in different states align—for example, if all businesses would prefer weaker state-aid enforcement because state-aid generally represents a transfer to capital owners from everyone else—then aggregating and focusing lobbying

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[182] *Cf.* McGinnis & Movsesian, *supra* note 26, at 531 (asserting in the WTO context that "protectionist groups inevitably seek discriminatory legislation"). *Id.* at 515 (observing that "[f]ree trade and democratic government face a common obstacle—the influence of concentrated interest groups").

[183] MCCORMACK & OLSEN, *supra* note 34, at 98.

[184] TFEU, *supra* note 3, art. 245 (independence of Commissioners). *See also* MCCORMACK & OLSEN, *supra* note 34, at 107-9 (independence of Commission staff).

[185] Massimo Bordignon et al., *Fiscal Federalism and Lobbying*, 92 J. PUB. ECON 2288 (2008) (concluding that centralization has salutary effects on lobbying when regional lobbies have divergent interests but exacerbates those effects when regional lobbies have aligned interests).

efforts at the center may increase rent-seekers' influence compared to the national level.[186]

IV. A New Era in State Aid

The last Part highlighted the unappreciated role of the traditional selectivity in striking a balance between market integration goals and Member States' interest in retaining regulatory and tax autonomy. In the tax area, traditional selectivity analysis, with its domestic-law reference base, allows the Commission to identify Member State tax regimes that single out cross-border commerce for unfavorable treatment without passing judgment on states' basic tax policy choices.

This Part explains that by substituting a normative reference base for the traditional domestic-law reference base as part of selectivity analysis, the Commission has become hopelessly entangled in tax policy matters that it has no authority or expertise to resolve. This Part explains how deviation from the traditional domestic-law-reference-base approach led the Commission in *Gibraltar* to tell a Member State that it could not operate a uniformly applicable property tax and payroll tax. Incredibly, the Court of Justice, likewise dispensing with the traditional approach to selectivity, upheld the Commission's decision.

In the pending cases involving U.S. multinationals, the Commission also has sought to jettison the domestic-law reference base in favor of a normative reference base for identifying state aid. Except for *Gibraltar*, which the Court of Justice affirmed in 2011, all of the cases discussed in this Part are on appeal to the EU courts.[187] The appeals will either affirm the expansion of state aid that began with *Gibraltar* or cabin the Commission's discretion. The pending cases therefore represent a crucial decision point.

A. Starting with *Gibraltar*

Gibraltar invalidated an entire corporate tax regime as state aid.[188] The case involved notified aid; Gibraltar submitted a proposed regime to the Commission for determination of whether it was state aid. The Commission denied Gibraltar permission to enact the regime, concluding

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[186] *Id.* On the other hand, the Commission's lack of political accountability presumably makes it relatively unsympathetic to such lobbying.

[187] *See* references in *supra* note 31.

[188] Joined Cases C-106/09 P and C-107/09 P, Gibraltar, ECLI:EU:C:2011:732 [hereinafter *Gibraltar* CJEU]. EU law governs Gibraltar as part of the United Kingdom. *See id*.

that the regime constituted state aid because, as applied, it would tend to exempt offshore companies.[189]

The proposed regime involved property and payroll taxes capped at an overall percentage of taxpayers' profits.[190] The Commission concluded that the regime was state aid, even though, by its terms, it applied uniformly to all taxpayers and therefore did not seem to raise issues of selectivity or individual aid because there was no deviation from the domestic-law reference base.[191] Although it was not individual aid and involved no overt selectivity, the Commission reasoned that the proposed tax base would favor offshore companies, which tended not to have payroll and property in Gibraltar, over onshore companies that tended to have property and payroll in Gibraltar. Thus, as applied, the proposed regime would disproportionately burden onshore companies.[192]

The General Court (then called the Court of First Instance) vacated the Commission's decision because the Commission had not used a domestic-law reference base.[193] According to the General Court, dispensing with the domestic-law reference base would "enable the Commission to assume the role of the Member State with regard to determination of that State's tax system."[194] The General Court went on to note that Member States "have competence to devise systems of corporate taxation which they consider the best suited to the needs of their economies" and the state-aid rules did not "prejudice… the power of the Member States to decide on their economic policy and, therefore, on the tax system… they consider the most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production."[195]

On appeal, however, the Court of Justice sided with the Commission; the Court of Justice emphasized that using the domestic-law-reference base in every case could open up loopholes in state-aid

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[189] *Gibraltar* CJEU, *supra* note 188, at paras. 85-110.

[190] *Gibraltar* CJEU, *supra* note 188, at paras. 8-25.

[191] This was essentially the view taken by the General Court, then called the Court of First Instance (CFI), which vacated the Commission's decision because the Commission did not show that the proposed Gibraltan regime discriminated. *See* Joined Cases T‑211/04 and T‑215/04, Gibraltar v. Commission, ECLI:EU:T:2008:595 [hereinafter *Gibraltar* CFI].

[192] *Gibraltar* CJEU, *supra* note 188, at para. 106.

[193] *Gibraltar* CFI, *supra* note 191

[194] *Gibraltar* CFI, *supra* note 191, at para. 145.

[195] *Gibraltar* CFI, *supra* note 191, at para. 146 (citing fundamental freedoms jurisprudence).

enforcement because a facially neutral regime could achieve the same result as a facially discriminatory regime "by adjusting and combining the tax rules in such a way that their very application results in a different tax burden for different undertakings."[196] The high court agreed with the Commission that, as applied, the proposed Gibraltan tax would discriminate in favor of offshore companies, and the Court accepted that the Commission could show selectivity not only by establishing a deviation from a domestic-law reference base, but also by looking to the practical effect of the regime.[197] Potentially adducing a new factor for judging state-aid cases, the Court of Justice specifically noted an additional problem with Gibraltar's regime. Because the proposed regime was not a comprehensive income tax, it failed to generate liability for "all companies."[198]

B. Recent Cases

In the recent cases involving U.S. multinationals, the Commission continued to move away from the domestic-law reference base. The Commission's theory in the recent cases was that Member States used secret administrative rulings to make sweetheart deals that allowed multinationals to pay too little tax.[199] The Member States and taxpayers argue that there were no sweetheart deals—the contested rulings were ordinary assurances from tax officials as to how national tax law applied to the taxpayer's particular facts. Thus, rather than *deviating* from domestic law, they argue that the rulings simply *applied* domestic law. This Article does not focus on whether the recent cases involved legitimate or sweetheart rulings. Instead, it focuses on the procedure by which the Commission establishes whether such rulings are legitimate.

Tax rulings are a tool used by many tax administrations around the world, including the Internal Revenue Service, to confirm application of tax laws to a taxpayer's particular set of facts.[200] Taxpayers typically seek

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[196] *Gibraltar* CJEU, *supra* note 188, at para. 93. For discussion of undue burdens, see *infra* notes 258 to 260.

[197] *Gibraltar* CJEU, *supra* note 188, at paras. 85-110.

[198] *Gibraltar* CJEU, *supra* note 188, at para. 100 (noting lack of "a generally applicable basis of assessment providing for the taxation of all companies covered by that regime").

[199] *See generally* Starbucks, *supra* note 110; Commission Decision 2016/2326 of Oct. 21, 2015 on State Aid Luxembourg granted to Fiat, 2016 O.J. (L 351) 1 [hereinafter *Fiat*]; *Apple*, *supra* note 5.

[200] Vestager Speech to TAXE, *supra* note 10, at 4, IRS, Rev. Proc. 2015-41, Procedures for Advance Pricing Agreements.

such rulings in cases involving high-value transactions or areas where the application of the law is uncertain or unpredictable.[201]

Most of the recent tax state-aid cases involved income-allocation rulings.[202] Vertically integrated multinationals have affiliates and business activities in many states, and each state must determine how much of the group's income it should tax. By international consensus, states use the arm's-length standard for dividing up income earned by a globally integrated business among the parts of that enterprise (including branches and separately-incorporated affiliates).

The arm's-length standard for allocating income to multinationals is designed to counter abusive profit-shifting by related taxpayers. Because related companies are controlled by the same owners, they can secure tax advantages by manipulating which entity in the group is deemed for tax purposes to earn the integrated enterprise's income. For example, a group can shift income from a subsidiary in a high-tax country to a subsidiary in a low-tax country by causing the high-tax subsidiary to buy goods or services from the low-tax subsidiary at an artificially inflated price. The high-tax subsidiary gets a larger expense deduction, and the low-tax subsidiary has a larger income inclusion. The group's overall profit remains the same, but it saves taxes due to the rate differential between the two countries.

The arm's-length standard counters this abuse by requiring both group members to report a market, or arm's-length, price on the transaction. The standard has faced significant and warranted criticism, but lack of viable alternatives has led to its widespread adoption. While the idea of a market price may seem straightforward, assigning prices in controlled transactions and allocating income among related companies is no simple matter. Over decades, the OECD states have worked by consensus to develop sophisticated and voluminous guidance on acceptable ways to allocate income from controlled-party transactions.[203] Memorialized in the OECD Transfer Pricing Guidelines and other OECD reports, this income-allocation guidance is used by most countries,

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[201] Raymond Luja, *EU State Aid Law and National Tax Rulings: In Depth Analysis for the TAXE Special Committee*, IP/A/TAXE/2015-02, at 9–11 (2015).

[202] *Apple*, *Starbucks*, *Fiat*, and *Amazon* all involve income allocation. The McDonald's case involves a tax treaty interpretation issue that has important implications for income allocation. James Kanter, *E.U. Investigates McDonald's Tax Deal With Luxembourg,* N.Y. TIMES (Dec. 3, 2015).

[203] Of the 28 EU members (including the United Kingdom), 23 are among the 35 OECD Member States. *Compare* OECD, List of OECD Member countries available at https://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm *with* EU, Countries, available at https://europa.eu/european-union/about-eu/countries_en.

including non-OECD countries.[204] Often, states incorporate into domestic law both the arm's-length standard and the OECD guidance for interpreting the domestic arm's-length standard, with each state modifying those standards as it sees fit.[205]

Application of the arm's-length standard is both notoriously complex and under-determinative, resulting in a range of acceptable income-allocation results, rather than a precise dollar figure.[206] No supranational body adjudicates disputes between countries on how to apply the arm's-length standard, although states have begun adding mandatory arbitration clauses to their bilateral tax treaties.[207]

To gain legal certainty, multinationals obtain rulings from governments on how to apply the arm's-length standard to their particular facts. Many countries, including the United States, encourage such rulings to avoid the risks of ex-post litigation over income-reporting and to prevent double taxation that may arise when two different countries apply the arm's-length standard differently to the same transaction or business activities. Thus, the United States encourages the use of bilateral and even multilateral rulings.[208] Such rulings are usually prospective—they describe the taxpayer's situation and how the taxpayer intends to allocate income from its economic activities.[209] Ruling procedures are generally open to any taxpayer, and the Commission acknowledges that rulings usually constitute a legitimate means of increasing legal certainty.[210]

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[204] TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (OECD Comm. on Fiscal Affairs 2017) [hereinafter 2017 OECD TRANSFER PRICING GUIDELINES].

[205] *See* S*tarbucks*, *supra* note 110, at paras. 409-12 (reporting that the Netherlands incorporated the OECD arm's-length standard into domestic law, Fiat, *supra* note 199, at paras. 219-311 (same). Ireland did not expressly endorse the arm's-length standard for allocating income to Irish branches of nonresident companies. *See Apple*, *supra* note 5, at para. 152. The Commission argued that arm's-length was Ireland's de facto standard. *Id.* at paras. 369-378.

[206] REUVEN S. AVI-YONAH, ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW 105 (2015).

[207] OECD, MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES FOR PREVENT BASE EROSION AND PROFIT SHIFTING (2016), arts. 18-26 (mandatory arbitration).

[208] Rev. Proc. 2015-41, *supra* note 200, at 19 (describing the IRS's "preference for bilateral and multilateral advance pricing agreements (APAs) over unilateral APAs").

[209] *Id.* at 3 (noting that APAs can apply to past or "rollback" years).

[210] Vestager Speech to TAXE, *supra* note 10, at 2 . Although it is valuable, legal certainty is not a relevant "advantage" for state aid purposes.

But rulings can do more than confirm the application of generally applicable laws to the taxpayer's specific facts. When such rulings are secret and unilateral—and all the recent state-aid cases involved secret unilateral rulings—states can use them to impose different, and more favorable, tax rules than those available under domestic law.[211] Disclosure in 2014 by whistleblowers of a large cache of Luxembourg's secret unilateral rulings for multinationals, an event known as LuxLeaks, revealed that Luxembourg deviated from its own laws and guidance in secret rulings.[212] As Professor Omri Marian put it, "Luxembourg was a tax-haven made by administrative practices, not by law. This enabled Luxembourg's officials to maintain a facade of a legitimate tax regime, when Luxembourg's was anything but."[213] LuxLeaks ignited a firestorm in Europe that led to a failed vote to censure Commission President Jean-Claude Juncker, who, prior to his presidency, served as minister of finance and prime minister of Luxembourg.[214]

News of Apple's aggressive tax plan sparked similar outrage. In 2012 and 2013, the Permanent Subcommittee on Investigations (PSI) of the U.S. Senate held a series of hearings on corporate tax avoidance. Testimony and other evidence collected from Apple executives revealed that Apple took advantage of a mismatch between U.S. and Irish tax-residence rules to avoid tax. Under then-applicable law, Ireland considered a company to be a tax resident of Ireland only if it was managed and controlled in Ireland.[215] In contrast, the United States long has used a place-of-incorporation rule for tax residence. By incorporating subsidiaries in Ireland that were managed and controlled in the United States, Apple was able to create companies that resided nowhere for tax purposes.[216] By

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[211] A large group of states recently agreed to exchange tax rulings with each other. OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT EXPLANATORY STATEMENT: 2015 FINAL REPORTS (2015) [hereinafter BEPS EXPLANATORY STATEMENT], at 14. Since 2017, EU law has required exchange of tax rulings between Member State tax administrations. See Council Directive 2015/2376/EU of 8 December 2015 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation O.J. L332 1.

[212] Marian, *supra* note 152, at 3 ("Luxembourg ignored its own administrative guidance, binding intergovernmental legal procedures, and well-established principles of international tax law.") (internal footnotes deleted).

[213] Marian, *supra* note 152, at 47 (emphasis in original).

[214] Ian Traynor, *Juncker Saved from Censure*, THE GUARDIAN (Nov. 27. 2014).

[215] *Apple*, *supra* note 5, at 9, n. 12 (describing old and new Irish tax-residence rules).

[216] Ireland has since changed its law to consider as an Irish resident any company incorporated in Ireland, but not regarded by any other state as resident there by virtue of management and control. *See* Irish Revenue, Tax Residence, available at https://www.revenue.ie/en/jobs-and-pensions/tax-residence/index.aspx.

exploiting favorable EU and Member State legislation and the favorable U.S. check-the-box rules, Apple was able to shift more than half its global profits to these nowhere companies.[217] Because neither the United States nor Ireland taxed these companies' worldwide income, Apple escaped tax on the majority of its global earnings.[218]

The Commission began its investigation of Irish rulings practices in mid-2013, just after Apple executives testified at the Senate PSI's hearings.[219] Citing the PSI's report, the Commission noted in its own *Apple* decision that one of Apple's Irish-incorporated entities paid tax to Ireland at an effective rate of 0.05 percent, much lower than Ireland's regular 12.5% rate.[220] Apple disputed this claim.[221] In response in part to complaints from high-ranking U.S. officials that the Commission disproportionately targeted U.S. multinationals,[222] the Commission expanded the scope of its investigation, eventually demanding that each Member State submit for Commission inspection all its tax rulings issued from 2010 to 2012.[223]

Although the Commission's rulings investigations are still ongoing, the Commission has already rendered final decisions in several cases involving U.S. multinationals. The Commission found that tax rulings by Ireland for Apple, by the Netherlands for Starbucks, and by Luxembourg for Amazon, Fiat, and McDonald's all conferred state aid.[224]

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[217] *See* S. SUBCOMM. ON INVESTIGATIONS, MEMORANDUM FROM OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE- PART 2 (APPLE INC.), at 10 (Comm. Print 2013).

[218] *Id.* at 42.

[219] The Senate PSI Apple hearings were in May of 2013. *Id*. The Commission sent its initial letter to Ireland asking for information on its rulings practices on June 12, 2013. *Apple*, *supra* note 5, at para. 1.

[220] *Apple*, *supra* note 5, at para. 20.

[221] Apple Inc., European Commission Opinion of August 30, 2016, Investor FAQ, at 2 (reporting to shareholders that Apple's global effective rate for that year was 26.1%, that it was one of the largest taxpayers in Ireland that year, and that it paid or accrued U.S. tax on its profits).

[222] Letter from Treasury Secretary Jacob Lew to Commission President Jean-Claude Juncker (Feb. 11, 2016) [hereinafter Lew Letter to Juncker].

[223] Background to the High Level Forum on State Aid of 3 June 2016 (DG Competition, Internal Working Paper), at para. 6. [hereinafter 2016 Commission State-Aid Forum Working Paper].

[224] *Apple*, *supra* note 5, at para. 452; *Starbucks*, *supra* note 110, at para. 450; *Fiat*, *supra* note 199, at para. 371. The final decision in McDonald's is pending, and Commission has not yet released the final decision in Amazon, though it announced its adverse decision and recovery order. *See* Commission's *Amazon* Press Release, *supra* note 9.

While the McDonald's case involves a tax-treaty interpretation issue,[225] the remaining cases questioned whether the states approved rulings that taxed too little of the taxpayer's income. A major dispute in these cases is how to establish that a taxpayer allocated too little income to a state. If a state approved a ruling that allocated the right amount, then it granted no advantage, and therefore conferred no state aid.

Because the Commission found that the Netherlands and Luxembourg adopted the OECD's arm's-length standard and the OECD Transfer Pricing Guidelines (sometimes with modifications) as their standard for allocating income, however, the Commission's decision in *Starbucks* and *Fiat* boiled down to a claim that each defendant state violated its own domestic law to grant favorable rulings to select multinationals.[226] Use of this domestic-law-reference-base approach to establish selectivity comports with prior Commission practice.[227]

But because Ireland had not adopted the OECD arm's-length standard for allocating income to Irish branches, the Commission faced a more difficult task of proving that Ireland granted Apple selective aid. The Commission argued that, notwithstanding that Ireland had not expressly incorporated it into domestic law, the arm's-length standard should nevertheless constitute the benchmark for establishing that Ireland conveyed aid to Apple.

The Commission advanced three alternative arguments. These arguments contradict each other, but the EU courts can uphold the Commission's decision if persuaded by any of them. First, the Commission argued that notwithstanding Ireland's protestations to the contrary, arm's length was, de facto if not de jure, the standard Ireland used to allocate income to branches, but Ireland deviated from it to favor Apple.[228] As a second alternative, the Commission argued that Ireland had

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[225] Commission Press Release, State aid: Commission opens formal investigation into Luxembourg's tax treatment of McDonald's (Dec. 3, 2015) IP/15/6221. *See* Fadi Shaheen, *Tax Treaty Aspects of the McDonald's State Aid Investigation*, 86 TAX NOTES INT'L 331 (2017).

[226] *Starbucks*, *supra* note 110, at paras. 409- 412; Fiat, *supra* note 199, at paras. 315-17. The final *Amazon* decision is not yet available.

[227] There is no stare decisis requirement for in the Commission's enforcement of state aid—the Commission need not follow its own decisional practice. Case C-138/09 Todaro Nunziatina, ECLI:EU:C:2010:291, para. 21). The CJEU follows its own precedents, and some of its precedents discuss or approve methods for identifying state aid. *See generally* MARC JACOB, PRECEDENTS AND CASE-BASED REASONING IN THE ECJ (2014).

[228] After examining of all of Ireland's branch-profit allocation rulings over ten years (amounting to only eleven such rulings), the Commission determined that Ireland

no consistent standard for allocating income to Irish branches, and this lack of a clear standard itself constituted a state-aid violation.[229]

The Commission's controversial third theory for how Ireland violated the state-aid rules was that the state-aid rules themselves require all states to allocate income according to the arm's-length standard, *regardless of domestic law*.[230] The Commission insisted that the state-aid arm's-length standard derives from EU law—rather than from Member States' incorporation of that standard into domestic law—and therefore the state-aid arm's-length standard could differ both from the OECD arm's-length standard[231] and from the Member State's own domestic-law version of arm's-length.[232] Notwithstanding this claim, in fleshing out its sui-generis arm's-length standard, the Commission relied heavily on OECD guidance.[233] Because the Commission claimed that the sui-generis arm's-length standard was independent of domestic law, however, the Commission did not limit itself to using OECD guidance that applied at the time of the contested rulings. Instead, it applied a mix of contemporaneous and modern OECD guidance to evaluate the contested rulings.[234]

Perhaps to shore up its claims in *Apple* about the sui-generis arm's-length standard, the Commission claimed in *Starbucks* and *Fiat* that, in addition to violating their own law, the Netherlands and Luxembourg also

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consistently accepted income allocations to branches that relied on the OECD arm's-length standard. *Apple*, *supra* note 5, at para. 371, n. 311.

[229] *Apple*, *supra* note 5, at para. 383.

[230] *Apple*, *supra* note 5, at para. 255.

[231] *See, e.g.*, 2016 NOTICE, *supra* note 22, at para. 173 (noting that rulings complying with the OECD Transfer Pricing Guidelines are "unlikely to give rise to State aid").

[232] It is not uncommon for states to modify arm's-length in some ways. For example, when OECD guidance had a strict hierarchy of methods, some states declined to incorporate the hierarchy, instead providing that taxpayers could choose among the OECD options the method that best fit its situation (so-called best method).

[233] *Apple*, *supra* note 5, at para. 322 (noting that, aside from OECD guidance, "no other alternative detailed and comprehensive analyses on methods of attributing profits are available to tax administrations and multinational enterprises to assist them in establishing arm's length conditions") (internal citations and footnotes omitted).

[234] *See, e.g., Apple*, *supra* note 5, at paras. 88-9, 272-3, 323 (relying heavily on the 2010 OECD branch profits attribution report, even though Ireland granted the *later* of the two contested rulings in 2007). *See also Starbucks*, *supra* note 110 (citing both the 1995 OECD Transfer Pricing Guidelines, which the Netherlands had incorporated into domestic law, and the 2010 OECD Transfer Pricing Guidelines, which post-dated the tax rulings at issue in the case).

violated the sui-generis arm's-length standard that applied regardless of domestic law.[235]

For good measure, in all three cases, the Commission also asserted as an alternative argument that the states conferred individual aid. On this conception, each ruling represented a secret bargain between the Member State and the particular taxpayer to allow the taxpayer to pay less tax than would be due under domestic law.[236] The Commission is permitted to presume selectivity in individual aid cases.[237]

C. Beyond Free Trade

In *Gibraltar* and the recent rulings cases, the Commission expanded its enforcement powers by interpreting state aid to encompass selective deviations from *ideal tax policies*. This novel state-aid conception is far broader than the traditional conception that encompasses only selective deviations from *generally applicable domestic law.*

The TFEU divides tax powers between the Member States and the EU central government. The Member States retain the lion's share of tax power, while the TFEU limits their ability to exercise that tax power in a way that discriminates against or selectively subsidizes private competitors on the basis of their nationality or other suspect classifications. Until *Gibraltar*, the approach of both the Commission and the Court of Justice to state aid was that if a state did not discriminate, then it did not violate the state aid rules.

By defining state aid as deviations from a domestic-law reference base that discriminated in favor suspect classes, the traditional selectivity requirement helped the Commission avoid becoming a supranational legislator that would pass judgment on Member State policy choices. Member States could, for example, apply low corporate tax rates or even forgo corporate taxation entirely as long as they applied the low rate to everyone without discrimination. Likewise, states could choose any tax base they wanted, as long as they applied that base to everyone the same

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[235] *Starbucks*, *supra* note 110, at para 264 ("The arm's length principle therefore necessarily forms part of the Commission's assessment under Article 107(1) of the Treaty of tax measures granted to group companies *independently of whether a Member State has incorporated this principle into its national legal system*") (emphasis added). *See* Fiat, *supra* note 199, at para. 228 (same).

[236] *Starbucks*, *supra* note 110, at para. 254, *Fiat*, *supra* note 199, at para. 218, *Apple*, *supra* note 5, at para. 244.

[237] Case C-15/14 P, *Commission v. MOL*, EU:C:2015:362, ¶ 60 ("the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective").

way. This approach represented a compromise between the harmful and salutary effects of Member State tax competition.

Under the old paradigm, sometimes income would go untaxed (or double taxed) due to differences in Member State tax systems. Such tax gaps and overlaps represent a cost of tax diversity,[238] and under the old approach, no particular state could be held responsible for higher[239] or lower[240] taxes that resulted from the interaction of two states' nondiscriminatory laws.

By reinterpreting selectivity as deviations from a normative reference base, rather than as deviations from a domestic-law reference base, however, the Commission has assumed the role of tax policymaker. Rather than asking whether a state treated some taxpayers better than similarly situated others, the emerging approach asks normative questions, including "Did the Member State adhere to the sui-generis arm's-length standard?" and "Will the Member State's proposed corporate tax base generate liability for "all companies?"[241]

Precedent provides no clear guidance as to how the Court of Justice will react to the recent cases. *Gibraltar* suggests two reasons the

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[238] Tolerance for costs arising from mismatches has limits. *See, e.g.,* Case C-250/95, Futura Participations SA v. Administration des contributions, ECLI:EU:C:1997:239 (analyzing when such mismatch costs become so disproportionate that they violate the fundamental freedoms as *restrictions*, even if nondiscriminatory). *Cf.* Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520 (1959) (invalidating under the dormant Commerce Clause a non-discriminatory state mudguard regulation that differed from the mudguard regulation of 45 other states because the deviating regulation imposed an "undue burden" on interstate commerce).

[239] *Cf.* Case C-403/03, Schempp v. Finanzamt München V, ECLI:EU:C:2005:446 (holding that even though cross-border taxpayer experienced more tax than a domestic taxpayer would, because the additional tax was due to a mismatch between German and Austrian tax law, Germany could not be held responsible for it under the fundamental freedoms). The Supreme Court came to the largely same conclusion. *See, e.g.*, Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) (accepting under the dormant Commerce Clause over-taxation due to a nondiscriminatory mismatch of allocation rules).

[240] *See, e.g.,* Commission decision on the groepsrentebox scheme which the Netherlands is planning to implement, O.J. 2009/L 288/26, (Nov. 4, 2009) [hereinafter *Groepsrentebox*] ¶ 118 (approving under the state-aid rules a uniformly applicable domestic tax rule that varied from the rules of other states and resulted in under-taxation). *See also* Schön, *supra* note 65, at 408 ("sovereignty of Member States in tax legislation… includes the power not to tax economic events").

[241] The Commission is currently investigating whether the United Kingdom defined income taxable under its CFC regime broadly enough; as a benchmark for what would be the appropriate reach of a CFC regime, the Commission pointed to recently adopted harmonized EU CFC rules. *See* State Aid SA.44896 (2017/C ex 2017/NN) – United Kingdom CFC Group Financing Exemption, C(2017) 7197 final (Oct. 26, 2017).

Court of Justice might uphold the recent Commission decisions. First, in *Gibraltar,* the Court of Justice approved the Commission's departure from the traditional domestic-law reference base, and so the Court may be willing to do so again in *Apple* and the other cases. Second, the Court's reasoning in *Gibraltar* suggests that the Member States are not free to choose their tax bases; instead, they must choose a tax base the generates liability for all companies, or at least, all profitable companies. This aspect of *Gibraltar* seemed to contradict published Commission guidance announcing that generally applicable measures are not illegal aid simply because they burden different firms differently (as all taxes do).[242] *Gibraltar* was particularly puzzling in light of the Commission's own CCCTB proposal, which would use property, payroll, and sales to allocate income among the states in which a multinational does business.[243] These factors were chosen because they proxy real economic activity, and the CCCTB seeks to align taxation with real economic activity.[244] If enacted into law, the CCCTB would thus result in very little income from offshore companies allocated to Gibraltar, a result usually regarded as salutary, not troubling. But in *Gibraltar*, the Commission and the Court of Justice condemned as state aid the same result—nontaxation of offshore companies' income by Gibraltar.[245]

On the other hand, the precedential value of *Gibraltar* is uncertain. First, the Court's statement that to survive state-aid scrutiny Gibraltar had to adopt a general income-tax base that would generate liability for "all companies" was dictum. The reason the Court upheld the Commission's decision was that the Court agreed with the Commission that while Gibraltar's proposed tax regime was facially neutral, it would discriminate on the basis of a suspect classification *as applied*. Second, in 2016 the

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[242] 1998 NOTICE, *supra* note 117, at para.14 ("The fact that some firms or some sectors benefit more than others… does not necessarily mean that they are caught by… State aid. Thus, measures designed to reduce the taxation of labour for all firms have a relatively greater effect on labour-intensive industries than on capital-intensive industries, without necessarily constituting State aid.").

[243] 2011 CCCTB Proposal, *supra* note 60, at 49-54.

[244] *See* Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) [hereinafter 2016 Consolidation and Formulary Relaunch], COM (2016) 683 final ("Since these factors are attached to where a company earns its profits, they are more resilient to aggressive tax planning practices than the widespread transfer pricing methods for allocating profit."). The 2016 Relaunch does not change the formulary proposal from the original 2011 CCCTB proposal, which is still pending before the Council. *See id*. at 1, 10.

[245] Although neither the Court nor Commission said so, the result in *Gibraltar* depended on lack of harmonization of tax regimes—if all the other Member States also had property and payroll taxes, the Commission presumably would not have been troubled by Gibraltar's.

Court of Justice expressly limited *Gibraltar* to its unique facts, in which the entire corporate tax regime constituted aid.[246]

Critics have charged the Commission with interpreting the state-aid rules in the recent cases to mandate "single taxation," an aspirational tax policy goal that ensures taxation of one hundred percent of a multinational's global income.[247] Single taxation may seem like a worthy—even uncontroversial[248]—goal, and countries increasingly coordinate their laws to promote single taxation through the same organization they long used to combat over-taxation due to mismatches, the OECD.[249] But the idea that all of a multinational's income must be subject to single taxation is fundamentally inconsistent with the notion that each state's tax base may differ from that of its neighbors. In the absence of harmonization, gaps (and overlaps) between countries' tax systems are inevitable.

Despite broad statements by Commission officials that all corporate income should be taxed,[250] and despite Commission press releases lamenting non-taxation of corporate income *as if that itself were enough to violate the state-aid rules*,[251] the pending cases do not overtly

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[246] Joined Cases C 20/15 P and C 21/15 P, World Duty Free Group, ECLI:EU:C:2016:981, paras. 73-76.

[247] *See , e.g.* AVI-YONAH, *supra* note 206, at 59-65 (giving history of the single-tax principle); Daniel S. Smit, *Recovery of Fiscal State Aid: Always Somewhere?*, KLUWER INT'L TAX BLOG (Oct. 13, 2016), http://kluwertaxblog.com/2016/10/03/recovery-of-fiscal-state-aid-always-somewhere (characterizing the Commission's Apple decision as holding Ireland "responsible to ensure single taxation").

[248] In reality, single taxation is controversial, in part because achieving it would require harmonization of tax bases, or, at a minimum, coordinated responses for dealing with tax gaps. *See* AVI-YONAH, *supra* note 206, at 9-10. Such coordination lacks political support. *See, e.g.*, 2002 EU Parliament Report, *supra* note 148, at 9 (reporting that the European Parliament "[d]oes not believe that gaps in corporate taxation run counter to the goal of increasing the European economy's competitiveness and dynamism").

[249] *See, e.g.,* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, ACTION 2 - 2015 FINAL REPORT (2015) (developing defensive measures for combatting mismatches that states can adopt unilaterally).

[250] Vestager Speech to TAXE, *supra* note 10, at 2 (expressing disapproval of OECD-approved one-sided income-allocation methods that may result in tax gaps).

[251] For example, in its press release about its final *Apple* decision—the Commission noted that Apple's profits "were not subject to tax in any country," as if that fact, by itself, represented a state-aid problem. Commission Press Release, *Ireland gave illegal tax benefits to Apple worth up to €13 billion,* IP/16/2923 (30 Aug. 2016) [hereinafter Commission's *Apple* Press Release]. Similarly, in its release about *Starbucks* and *Fiat*, the Commission noted that Starbucks profits "are shifted abroad, where they also are not taxed." *Commission Press Release, Commission decides selective tax*

endorse single taxation, and they do not wholly dispense with the selectivity requirement. Instead, under alternative arguments in each case, the Commission determined that the challenged tax rulings were selective because they conferred individual aid or because Member States used them to deviate from generally applicable domestic law in favor of particular companies.[252] Thus, the EU courts face an important choice in the upcoming appeals. They could uphold the cases on modest, traditional grounds, or they could expand the Commission's state-aid charter in the tax area.[253]

V. Criticism of the New Conception of State Aid

This Part argues that in the pending appeals, the EU courts should reject the Commission's attempts to reinterpret state aid as deviations from ideal tax policies. Instead, the courts should reaffirm the centrality of traditional selectivity analysis, with its domestic-law reference base. This Part argues that the new standard is not needed to uphold the results in the recent cases. Additionally, by jettisoning the traditional selectivity requirement, the Commission would simultaneously jettison selectivity's internalization and democracy-reinforcing effects. The Commission's novel approach inappropriately positions the Commission as a supranational tax lawmaker, though it lacks the legitimacy, expertise, and capacity to fill that role. Finally, by imposing stricter tax competition rules than those agreed in the OECD, the Commission's new approach puts the EU at a competitive disadvantage in the global contest for inbound investment, while invoking the ire of major trading partners whose cooperation Europe needs on a number of pressing international tax issues.

A. The New Conception Is Not Needed

The most controversial aspect of the Commission's recent decisions so far has been development of the sui-generis arm's-length standard for allocating income from cross-border economic activity.[254] Adoption of the sui-generis standard is puzzling because it does not seem to directly respond to traditional state-aid concerns. As long as a state's

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advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules, IP/15/5880 (Oct. 21, 2015).

[252] *See* references in *supra* note 236.

[253] Questions of law, including whether the state-aid rules impose upon the Member States a requirement of arm's-length income allocation, receive de novo review. Case T-342/99 Airtouses v. Commission 2002 E.C.R. I- II-2585.

[254] *See, e.g.,* Schön, *supra* note 65, at 427 ("it should be accepted that there exists no common 'international tax system' which forms the baseline") and states "can apply different theoretical concepts to transfer pricing discipline" which "can lead to different outcomes under the respective rules."

income-allocation rules do not themselves upset competition between private parties on the basis of a suspect classification, then as long as the state applies those allocation rules consistently across taxpayers, no taxpayer should experience a competitive disadvantage relative to the others on account of those rules, regardless of the fact that states may have income-allocation rules that differ from each other.[255] Thus, the sui-generis arm's-length standard seems superfluous to the Commission's traditional state-aid role as arbiter of state interference with private competition and market integration.

A related criticism of the new approach is that the Commission did not need it to reach the result in any of the recent cases. In *Apple*, *Starbucks,* and *Fiat*, in addition to arguing that the Member States violated the sui-generis arm's-length standard, the Commission also concluded that the Member States issued rulings that resulted in taxation for the multinationals that was more favorable than what those multinationals could have received under each state's own income-allocation rules.[256] The traditional conception of state aid already captures this kind of sweetheart ruling as individual aid, and with the approval of the Court of Justice, the Commission has struck sweetheart rulings as state aid since at least the mid-2000s.[257]

More generally, there is no good reason for the Commission to apply stricter state-aid standards for tax rules than for other forms of state regulation. Different rules for tax make little sense because tax and other forms of subsidization (including direct spending) are often substitutes. Interpreting the state-aid rules to apply more strictly to tax than other spending measures might alter the mode of subsidization without affecting the overall amount of unwanted subsidization.

B. Internalization and Tax Diversity

While the traditional approach to selectivity would support recovery in *Apple*, *Starbucks,* and *Fiat*, it would not support the outcome in *Gibraltar* because Gibraltar's proposed payroll and property tax was *nondiscriminatory* and therefore nonselective. An interpretation of state aid limited to selective deviations from a domestic-law reference base

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[255] *See* Knoll & Mason*, supra* note 78, at 326-329, 336-342 (showing states can have different income-allocation rules from each other without distorting competition, as long as each state applies its own allocation rule even-handedly to all comers).

[256] *See Starbucks*, *supra* note 110, at paras. 409- 412. *Fiat*, *supra* note 199, at paras. 315-17, 325-336. *Apple*, *supra* note 5, at paras. 369-378.

[257] *See, e.g.* Joined Cases C-182/03 and C-217/03, Forum 187 ASBL, ECLI:EU:C:2006:416. (striking the Belgian coordination center regime as state aid because under it Belgium would issue rulings that favorably deviated from Belgian income-allocation rules, which implemented the arm's-length standard).

would have to accept the regime proposed in *Gibraltar*, despite the incentives it would create for shifting income. Similarly, such a conception of state aid must accept Ireland's generally applicable 12.5 percent corporate tax rate and Estonia's choice not to tax corporations at all.

When Gibraltar, Ireland, and Estonia implement nonselective regimes, they do so with the hope of distorting taxpayer behavior. They want companies to move activities or income from higher-tax jurisdictions to their own territory where it will be subject to little or no tax. At the same time, however, when such states adopt *uniformly applicable* attractive regimes that do not discriminate, they internalize more of the costs of those regimes into their own economies than they would if they discriminated. The Irish, Estonian, and proposed Gibraltan regimes are designed to be more attractive than those of other EU Member States. But those attractive regimes also apply equally to both insiders and outsiders, to interstate as well as domestic commerce.

Once enacted, Gibraltar's nonselective property and sales tax regime would have distorted not only multinational's locational decisions, but also *domestic* companies' real factor location decisions. The proposed regime would have encouraged domestic companies to move taxable factors—payroll and property—offshore, which, in turn, would have depressed Gibraltar's tax revenue and reduced the presence of productive factors in Gibraltar. Because Gibraltar was willing to impose the same income tax base on everyone, it would have internalized the costs of its attractive regime in the same way that other states internalize the costs of generally applicable low tax rates. Similarly, to be able to offer multinationals a 12.5 percent corporate tax rate, Ireland has to collect that—and no more—from domestic companies. By forcing states to internalize more of the costs of their favorable tax policies (or regulations), the selectivity requirement makes states less likely to adopt them. The selectivity requirement therefore reduces the risks of tax (and regulatory) competition for other states without unduly constraining any state's policy choices.

An interpretation of tax state aid limited by traditional notions of selectivity cannot entirely rule out tax competition. Likewise, state-aid control cannot completely rule out regulatory or spending competition. Nor should they. The selectivity requirement's use of a domestic, rather than a normative, reference base leaves major tax policy decisions to the states. At the same time, its nondiscrimination mandate forces states to internalize more of the costs of their competitive policies. In contrast, the state-aid concept becomes unbounded when the Commission reads out the selectivity requirement, as it did in *Gibraltar,* and when it substitutes a normative baseline for the domestic-law baseline, as it did in *Apple*, *Fiat*, and *Starbucks*.

Recall the Irish rule that regarded a company as tax-resident in Ireland only if it was managed and controlled in Ireland. The rule was nondiscriminatory, and therefore, it was not state aid under the traditional conception, notwithstanding that when combined with the (also nondiscriminatory) U.S. place-of-incorporation rule it resulted in a gap that Apple exploited to create stateless companies. The traditional conception of state aid does not reach such mismatches, so a cost of the traditional conception is that taxpayers will continue to exploit them. A similar problem persists in the U.S. states, which use a variety of rules for allocating multistate income that can result in both over- and under-taxation.[258] The Supreme Court has held that tax overlaps arising from different, but nondiscriminatory, income allocation rules do not violate the dormant Commerce Clause.[259] The Supreme Court has emphasized both

[258] Solicitous of avoiding undue infringements on state tax sovereignty, the Supreme Court has long employed the internal consistency test to determine whether state tax policies are unconstitutional. Under the internal consistency test, the Court assumes that all states apply the challenged state's law, and then it checks whether under hypothetical harmonization interstate commerce bears a greater tax burden than in-state commerce. Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) (holding that a state was free to adopt an internally consistent apportionment formula, even though it differed from the formula used by forty-four other states and may have led to duplicative taxation). *See also* Comptroller of the Treasury of Maryland v. Wynne, 135 S. Ct. 1787 (2015) (reaffirming primacy of internal consistency test to dormant Commerce Clause analysis in tax cases). *See also* Knoll & Mason, *supra* note 78 (explaining the internal consistency test and why it works to identify tax rules with protectionist effects).

[259] *Moorman*, at 277 ("Even assuming some overlap [in nondiscriminatory allocation rules], we could not accept appellant's argument that Iowa, rather than Illinois, was necessarily at fault in a constitutional sense."). Analyzing *Gibraltar* under the Supreme Court's internal consistency test is revealing. Gibraltar proposed to apply its property and payroll taxes the same way to all companies, whether multinationals or domestic standalone companies. If every EU Member State adopted the proposed Gibraltan regime, it would pass the internal consistency test. If all states taxed all companies on the basis of the company's payroll and property in their territory, then although Gibraltar would not collect much tax from offshore companies that had little payroll and property in Gibraltar, those same companies would pay tax wherever they had their payroll and property. Thus, under a universalized Gibraltar payroll-and-property tax, all companies would be taxable on 100% of their income (just as they would be if all the states adopted the CCCTB, which has much in common with the proposed Gibraltan regime). The result under the internal consistency test—that Gibraltar would be permitted to retain its proposed regime—might seem unsatisfying. After all, the Gibraltan regime would favor offshore companies because only Gibraltar would use it, while every other state continued to use comprehensive corporate income taxation. Indeed, it is hard to escape the conclusion that Gibraltar designed the regime to create a nondiscriminatory mismatch with other states that would favor offshore companies registered in Gibraltar. But to attack nondiscriminatory mismatches, the Commission and the EU courts would have to use the EU's equivalent of the dormant Commerce Clause's prohibition of "undue burdens." *Compare* Commission decision on the groepsrentebox scheme which the Netherlands is planning to implement, O.J. 2009/L 288/26, (Nov. 4, 2009) (approving under the state-aid rules an internally consistent Member State rule that resulted in under-taxation because it varied from the rules of other states) *with* Kassel v. Consolidated

that each state is sovereign to choose the income allocation rule it prefers—as long as it does not discriminate—and that the Court has no authority to impose its own preference on the states regarding a harmonized allocation rule.[260] Of course, no supranational authority exists that could force the United States and Ireland to use the same residence rule, but mismatches can be (and have been[261]) eliminated within the EU by legislation passed under the procedure provided in Article 115.

Contrast the mismatch between the nondiscriminatory American and Irish tax-residence rules with *selective mismatches*. After analyzing a large cache of Luxembourg's confidential tax rulings that became publicly available after LuxLeaks, Professor Omri Marian concluded that Luxembourg issued rulings to taxpayers that created *bespoke mismatches for particular taxpayers.* In contrast with generally applicable tax residence rules, bespoke mismatches would constitute selective state aid.[262] Because bespoke mismatches would not be uniformly available to all taxpayers, they would meet the selectivity requirement under a traditional state-aid analysis. Again, the reason for Luxembourg to construct bespoke, rather than generally available, tax benefits is to minimize costs. If, to avoid state aid, Luxembourg must convey the relevant benefit to everyone, it becomes a less attractive policy from Luxembourg's perspective.

The traditional approach to selectivity cannot rule out the possibility that Luxembourg will enact a generally applicable tax system that is more attractive than that of its neighbors. But in a common market that promotes limited regulatory competition among the states, that is a perfectly appropriate result.

Freightways Corp., 450 U.S. 662 (1981) (dormant Commerce Clause case holding that state's 60-foot truck length limit unduly burdened interstate commerce when neighboring states had a 55-foot rule; 55-foot rule was not justified by road safety concerns). The fundamental freedoms contain the EU's undue burden requirement ("restrictions" in EU parlance). *See* Ruth Mason & Michael S. Knoll, *Waiting for Perseus: A Sur-Reply to Professors Graetz and Warren*, 67 TAX L. REV. 375, 400-3 (2014).

[260] *See Moorman*, at 280 ("the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.").

[261] *See* references to EU-level anti-corporate-tax-abuse directives, *supra* note 58.

[262] *See generally* Marian, *supra* note 152 (conducting empirical study of Luxembourg's tax rulings); see also Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89 (2004) (conducting theoretical study of governments' motivations to create arbitrage opportunities).

C. Commission Lawmaking

Until *Gibraltar*, no case—whether decided under the fundamental freedoms or the state aid rules—even hinted that any provision of the EU Treaties required Member States to tax "all companies." If the state-aid rules require not just nonselective taxation, but also adherence to particular tax policies chosen by the Commission, including particular tax bases and income-allocation rules, then the state-aid rules restrain Member State tax autonomy more than has generally been understood. After *Apple*, U.S. leaders,[263] Member States,[264] tax experts[265] and even a former Commissioner of Competition[266] criticized the Commission for enlisting state-aid control into service of broader tax harmonization and tax policy

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[263] *Senate Finance Committee Letter to Treasury Secretary Jacob Lew, Bipartisan Concern over Targeting of American Firms* (May 23, 2016) [hereinafter *Bipartisan Senate Finance Committee Letter*], at 1 ("Commissioner Vestager states that the [Commission] is now using State aid as one of its 'tools' to achieve a 'reform agenda,' which confirms our suspicion that these cases are about more than objectively enforcing existing competition policies."); Lewis, *supra* note 8 (quoting Lew for the proposition that "[o]ur concern with the European Commission's action is that it is using state aid theory to make tax law… that overrides national tax law authority").

[264] *See, e.g.,* Ireland's *Apple* Appeal, *supra* note 31 (arguing that "the decision exceeds the Commission's competence under Article 107(1)"); Netherlands' *Starbucks* Appeal, *supra* note 31, at 50 (arguing that the Commission judged the Starbucks ruling by whether it deviated from an EU arm's-length standard, which the Netherlands argues does not exist); Luxembourg's *Fiat* Appeal, *supra* note 31, at 59 (arguing that "the Commission's novel formulation of the arm's length principle introduces complete uncertainty and confusion as to when an advance pricing agreement, and indeed any transfer pricing analysis, might breach EU state aid rules").

[265] *See, e.g.*, Christiana HJI Panayi, *The Europeanization of Good Tax Governance*, 2018 YEARBOOK OF EUR'N L. 1, at 51-2 (concluding the Commission is promoting "an expansionist agenda leading to further harmonization of (corporate) tax laws" and arguing that the Commission has cleverly rebranded "harmonization" to the "better-sounding concept of good tax governance"); Finley, *supra* note 70, (reporting the technical advisory board on state aid of the German Ministry of Finance as describing state-aid control in the following terms, "Whoever has the right to prohibit $n - 1$ alternatives of a given set of n options has the ultimate right to choose the only possible alternative."); *See also* BACON, *supra* note 66, at 5 (referring to the recent investigations in concluding that "[s]tate aid is being partly used as a tool to incentivize tax harmonization").

[266] In an op-ed, Neelie Kroes, EU Commissioner for Competition from 2004 to 2010 who now works for technology companies but claims that "nobody will accuse me of being lax on state aid enforcement," argued that "EU member states have a sovereign right to determine their own tax laws. State aid cannot be used to rewrite those rules. However, the current state aid investigations into tax rulings appear to do exactly that"). Neelie Kroes, *Why EU state aid is not the right tool to fight tax avoidance,* THE GUARDIAN (Sept. 1, 2016).

goals. If DG-Comp will make tax policy, it is worth thinking about its legitimacy, expertise, and capacity to do so.[267]

1. Legitimacy & Expertise

If the Court of Justice approves the Commission's attempt to redefine state aid as deviations from a normative base, and if, as the Commission proposes, only the Commission gets to set the normative base, then the state-aid rules improperly bypass the rigorous tax legislative procedure set forth of Article 115, which requires unanimous agreement of the Council in consultation with Parliament to pass EU tax laws.[268]

Like Article 115, the principle of subsidiarity also cautions against unnecessary expansion of EU powers relative to those of the states. Subsidiarity prevents the EU from acting in areas of shared competence or exclusive Member State competence (like tax) unless the desired objective cannot be achieved by the Member States "either at central level or at regional and local level."[269] The Member States have been cooperating since 2013 with a large number of non-EU states through the OECD BEPS project to combat harmful state tax practices and corporate tax avoidance.[270] Thus, EU action in the same area arguably is not required.

Presumably, one reason the Commission and Court of Justice have stayed out of the business of tax-base definition until now is that such choices are fundamentally political and therefore not susceptible to Commission or judicial resolution.[271] Tax policymaking is a complex affair with profound political and social implications.[272] Even if it were generally agreed that major business tax decisions should be made at the EU level, for example, to save costs or reduce spillovers,[273] there are more

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[267] Many have written about the importance of subject-matter expertise to the quality of legislative and regulatory products. *See generally* Surrey, *supra* note 120.

[268] *See* TFEU, *supra* note 3, art. 115.

[269] TEU, *supra* note 38, art. 5(3) (subsidiarity).

[270] *See* discussion in text accompanying *infra* notes 296 to 298.

[271] *See* Brooks, *supra* note 174 (describing a variety of income tax bases and concluding "income is not a pure, external concept, but actually a constructed concept that necessarily embodies policy, and therefore political, goals").

[272] See *id.* (arguing that the choice of a tax base reflects normative and political judgments).

[273] Centralized decision-making can save costs by preventing states from duplicating learning efforts, and it can improve distributive efficiency by accounting for spillovers. Thus, economists recognize that, for example, taxes for redistribution are more efficient at higher levels of government where they have a smaller impact on movement of people and other productive factors. *See* Oates, *supra* note 84, at 1121. In contrast, tax

expert and more accountable bodies at the EU that could do it.[274] Indeed, DG-Tax has taken the leading role in drafting EU tax policy documents and legislation and for passage under Article 115. While DG-Comp can always hire more tax lawyers, it is unlikely that it could (or should) replicate the expertise of other EU and national institutions.[275]

Lack of tax expertise in DG-Comp has already created problems. For example, it is unclear whether Commission staff appreciated the broader implications of developing a new arm's-length rule that would apply independently of domestic law. In addition to creating monumental uncertainty for multinational taxpayers and infuriating longtime OECD partners that openly questioned the competence of the Commission to apply international tax standards,[276] the recent decisions seem to make it illegal for Member States to unilaterally adopt DG-Tax's star legislative proposal. DG-Tax has been pushing the CCCTB, major EU tax reform legislation that would require all the Member States to use formulary apportionment, *rather than arm's length*, to allocate income from cross-border transactions.[277] But if we take seriously the Commission's assertion that the TFEU requires Member States to allocate income according to the Commission's arm's-length standard, then unilateral Member State adoption of the CCCTB-type formulary is illegal, at least if (as contemplated in the CCCTB proposal) formulary applies to multinational, but not domestic, companies.[278]

2. Capacity to Fix Income Shifting

A related concern is whether the state-aid rules are up to the tax policy tasks the Commission has set for them. Consider *Apple*. Apple brazenly shifted profits from the United States and from the rest of the EU

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policies that respond to local conditions or fund local public goods, including schools, are more appropriately assessed at the local level. *Id.*

[274] Tax policymaking by the Council is itself problematic from an agency perspective, because it moves the locus of decision-making from national parliaments to representatives sent to the Council by national executives.

[275] *See* TREASURY WHITE PAPER, *supra* note 16, at 20 (noting that the allocation rules "describe a framework of analysis and methodologies that are highly dependent on each case's facts. For this reason, the tax authorities of the United States and EU Member States generally have entire departments whose sole responsibility is to examine transfer pricing issues").

[276] *Bipartisan Senate Finance Committee Letter*, *supra* note 263, at 2 (questioning the "competency" of the Commission to apply "international tax standards").

[277] 2011 CCCTB Proposal, *supra* note 60, at 49-55 (formulary).

[278] Adoption of CCCTB at the EU level, rather than unilaterally, would not be state aid because any advantage is conferred on multinationals would not be "granted by a Member State;" instead it would be aid granted by the EU.

to its Irish-incorporated-but-nowhere-resident subsidies. But because the Commission's case proceeded only against Ireland, the only thing that the Commission could do in *Apple* was reallocate to Ireland the profits that Apple had shifted to nowhere. The Commission could not put the profits where they substantively belonged—in the United States where Apple's engineers work or Germany, France, Italy, and the other EU states where Apple's customers reside.[279]

The Commission's conclusion in *Apple*—that half of Apple's *global profit* belonged in Ireland—defies common sense. Tellingly, in its *Apple* decision the Commission claimed that if other countries, including the United States, were to tax the profits that Apple had assigned to nowhere, such taxation by other countries would lower the state-aid recovery in Ireland.[280]

The Commission's suggestion that other states could essentially share in the recovery calls into question the Commission's main claim in *Apple*—that Ireland failed to collect *Irish* tax. If the tax was, in substance, due not to Ireland, but rather to the United States or some other country, it raises doubts about whether Ireland committed state aid by not collecting it. That Apple slipped the tax grasp of countries where it substantively earned income does not necessarily mean that it Ireland can or should tax Apple on the shifted profit. Apple certainly avoided tax, but to find that Ireland conferred illegal aid, the Commission must show that Apple avoided *Irish* tax.

D. State Aid in Global Context

This Subpart briefly considers the political implications of the Commission's recent decisions. The new approach injects uncertainty into an EU legal and political order already besieged by destabilizing forces. It also puts the EU at a competitive disadvantage by staking out a position on harmful tax competition that is stricter than that of its major trading partners. Finally, the new approach has caused a rift with non-EU Member States, most notably the United States.

1. The EU in Crisis

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[279] Commission staff wrote that the goal of state aid, like that of the BEPS project, was "to ensure companies pay the taxes they owe in the Member States where they generate economic value." *Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Report on Competition Policy 2015* (Commission Staff Working Document), SWD (2016) 198 final (Jun. 15, 2016), at 56.

[280] Commission's *Apple* Press Release, *supra* note 251, at 3-4.

In the past decade, the EU has suffered major setbacks, including the Eurozone crisis and Brexit. Economic hardship, political instability, and unprecedented migration have revealed the fragility of Europe.[281] In this context, it is not clear that the time is ripe for the Commission to make a bold move to control Member State corporate tax policies.

The Commission's decisions have caused consternation in the Member States. The *Apple* decision plunged Irish Parliament into debate over whether to appeal the Commission's decision or instead to accept the "€13 billion bauble [that] has been dangled in front of Irish noses."[282] Whereas it might seem obvious that Ireland would accept, rather than contest, the recovery order, what is at stake for Ireland is not only its finance ministry's ability to make credible commitments to taxpayers, but also Ireland's reputation as a cooperative, if low-tax, member of the international tax community.[283] Irish Parliament strongly backed appeal.[284]

Even large high-tax countries have expressed concern over the breadth of the Commission's approach. Countries with relatively large economies, like Germany, could be expected to benefit from strong state aid enforcement. For example, Germany has a direct interest in other Eurozone countries' fiscal responsibility, and state aid can improve states' fiscal responsibility by preventing them from conferring subsidies.[285] Additionally, Germany could be expected to indirectly benefit from state-aid enforcement actions against the small, low-tax EU states that poach business and tax base from their higher-tax neighbors. Nevertheless,

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[281] *See generally* THE EUROPEAN UNION IN CRISIS, *supra* note 52.

[282] J.P. Finet, *Apple Ruling is EU Power Grab, U.K. and Irish MEPs Argue*, TAX NOTES (Sept. 15, 2016) (quoting Irish MEP Marian Harkin at the European Parliament's hearings on the Apple decision).

[283] Michael Noonan, then finance minister, moved that Irish Parliament should appeal the Apple decision "to defend the integrity of our tax system; to provide tax certainty to business; and to challenge the encroachment of EU state aid rules into the sovereign member state competence of taxation." Henry McGee, *Ireland to defend 'integrity' of tax system in Apple appeal*, IRISH TIMES (Sept. 3, 2016).

[284] Irish government wins strong backing by parliament for EU Apple appeal, Reuters (Sep. 7, 2016). Irish Prime Minister Enda Kenny told Parliament, "This is not a Commission finding that stands by a small country that has played by the rules. It cannot be allowed to stand." *Id*.

[285] Monetary union increases risks to other states from irresponsible fiscal policies. A German member of European Parliament expressed this view during hearings on the *Apple* decision. He said that "the real scandal" was the Irish "should have used their own taxes to solve their problems" instead of receiving crisis aid from other EU countries). Finet, *supra* note 282 (quoting Bernd Lucke).

experts within Germany have expressed concern over the breadth of the Commission's approach.[286]

Similarly, when the European Parliament held hearings on the *Apple* decision before the Brexit vote, among the most vocal critics of the Commission's investigations were British members. British MEP Campbell Bannerman called the decision an "EU power grab… a tax trespass," while another, Steven Woolfe, called it "an attack on the tax sovereignty of EU nation states by the back door… [T]he EU has weaponized… competition law."[287] Some commentators even connected Brexit directly to the Commission's *Apple* decision.[288] By overstepping its bounds, the Commission adds pressure to a situation already stressed by multiple crises.

2. The EU as a Competitor for Investment

Limiting harmful tax competition *within the EU* is important because monetary union and removal of internal barriers to EU trade and investment have made the EU states relatively more susceptible to harms from tax competition.[289] At the same time however, tax competition is a global problem, and controlling it only in the EU may harm the EU relative to the rest of the world. As the OECD recognized in 1998, "[t]he broader the economic grouping of countries engaged in [the project to limit harmful tax competition], the greater the effectiveness of any solutions proposed, since this would minimise any displacement of activities to jurisdictions with harmful tax practices outside of the participating countries."[290]

When the EU endorses stricter limits on tax competition than those in place outside the EU, it risks making the EU unattractive relative to other jurisdictions. A spokesperson for British Prime Minister Theresa May highlighted this feature of state-aid enforcement by inviting Apple to

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[286] *See generally* GERMAN FINANCE MINISTRY REPORT, *supra* note 154, at 2.

[287] Finet, *supra* note 282.

[288] Max Bearak, *How the E.U.'s ruling on Apple Explains Why Brexit Happened*, WASH. POST (Aug, 30, 2016) (noting the popularity of the Twitter hashtag #Irexit following the *Apple* decision).

[289] Michela Redoano, *Tax Competition Among European Countries: Does the EU Matter*, 34 EUR'N J. POL. ECON. 353 (2014) (using theoretical model to show that reductions in cross-border investment costs due to EU membership exacerbates tax competition among the members and empirically conforming the results of the model). *Cf.* 1998 OECD REPORT, *supra* note 150, at 13 (noting that tax competition only became a problem with globalization).

[290] 1998 OECD REPORT, *supra* note 150, at 10.

move from Ireland to the United Kingdom post-Brexit.[291] Mehmet Simsek, Turkey's deputy prime minister, tweeted simply, "Apple should move to Turkey. Happy to provide more generous tax incentives. Won't have to deal with EU bureaucracy."[292]

By using normative (rather than domestic law) standards for judging state-aid violations, the Commission exacerbates the problem of stricter tax competition control within the EU. This practice spooks business and investors, who lose the ability to predict their tax outcomes.[293] For example, in a letter to Chancellor Merkel and other European leaders, the CEOs of 185 U.S. companies likened the Commission's *Apple* decision to expropriation and declared that "in interest of all countries that respect the rule of law, this decision must not be allowed to stand."[294] The CEOs warned that the *Apple* precedent was a "grievous self-inflicted wound" that would chill investment in Europe.[295]

In contrast, limiting state-aid enforcement to regimes that are selective in the traditional sense would not create as much of a divergence between the EU and the rest of the world because the traditional conception of selectivity largely comports with the international approach to identifying harmful tax practices.

The countries participating in the G20/OECD BEPS Project considered deviation from a domestic-law reference base to be a defining feature of harmful tax practices. Drawing on earlier work by the OECD in the late 1990s, a 2015 BEPS report stated that

> to be considered preferential, [the] key point is that the regime must be preferential in comparison with the general principles of taxation in the relevant country, and not in comparison with principles applied in other countries. For example, where the rate of corporate tax applied to all income in a particular country is 10%, the taxation of income from mobile activities at 10% is not preferential,

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[291] Lee A. Sheppard, *EU Pulls the Curtain on Apple's Tax Magic*, TAX NOTES (Sep. 6, 2016).

[292] Simsek, Mehmet (memetsimsek), Aug. 30, 2016, 6:55 a.m. Tweet.

[293] Business Roundtable Letter to Merkel, *supra* note 180, at 2.

[294] *Id.* at 1.

[295] *Id.* at 1-2 (noting that "companies should have complete confidence that sovereign countries are committed to honoring their laws")

> even though it may be lower than the rate applied in other countries.[296]

Continued adherence to the traditional domestic-law-reference base approach as part of selectivity analysis presumably would result in Commission rulings that identified as state aid Member State provisions that other countries would be more likely to agree involve harmful tax competition. Such rulings therefore could be expected to generate less controversy than the Commission's recent attempts to define state aid as deviations from a normative reference base.[297] Similarly, adhering to the domestic-law-reference-base approach would prevent EU state-aid law from getting too far ahead of global practice, thereby worsening the EU's competitive position relative to the rest of the world.

Finally, the need for corporate-tax state-aid enforcement by the Commission also may be declining due to the success of the BEPS Project. As part of BEPS, a large number of countries, including all of the G20 and OECD members, committed to adopt reforms to counter widespread corporate-tax avoidance, including the kinds of abuse at issue in the recent rulings cases.[298] These reforms include peer reviews of Member State tax regimes to determine whether they contain harmful tax practices, automatic exchange of certain types of formerly secret tax rulings (including those covered by the recent state aid cases), significant amendments to the OECD Transfer Pricing Guidelines to make them more robust, country-by-country income reporting rules that will prevent companies from keeping states in the dark about their activities and reported income in other states, and expanded transfer-pricing documentation requirements for taxpayers.[299]

3. Spillovers to Non-EU Countries

Due to the novelty of the Commission's theory of selectivity and the disproportionate investigation of U.S. multinationals, the recent decisions caused a major conflict between the EU and the United States.[300]

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[296] OECD, FINAL ACTION 5 REPORT, *supra* note 158, at 19 (laying out the latest transgovernmental effort to combat harmful tax practices).

[297] The Treasury Department complained that the Commission's recent decisions were "inconsistent with international norms and undermine the international tax system"). TREASURY WHITE PAPER, *supra* note 16, at 1.

[298] BEPS Explanatory Statement, *supra* note 211.

[299] *Id.* None of these reforms were effective at the time the facts of the cases discussed in this Article arose.

[300] TREASURY WHITE PAPER, *supra* note 16, at 1 (arguing that the "Commission has advanced several previously unarticulated theories as to why its Member States' generally available tax rulings may constitute impermissible State aid in particular cases.

Of the Commission's five recent investigations against specific companies, four involved U.S. multinationals, and only one involved a European company.[301] Itai Grinberg, a U.S. law professor, testified to Congress that the Commission's discrimination would justify retaliation by the United States,[302] a suggestion that members of Senate Finance Committee took seriously enough that they asked Treasury to consider it.[303] This led to predictions of a "tax war" between the United States and Europe.[304] Then-Treasury Secretary Jacob Lew wrote a letter to European Commission President Jean-Claude Juncker expressing concern that the Commission discriminated against U.S. multinationals.[305] This charge provoked the Commission to respond that "there is absolutely no bias against U.S. companies."[306]

Across party lines and branches of government, U.S. officials specifically condemned the Commission for substituting its own normative views for domestic-law arm's-length standards. For example, the Senate Finance Committee wrote to then-Treasury Secretary Lew observing that "the Commission appears to be ignoring the national practice and law of its Members and to be imposing its own new standard for transfer pricing determinations."[307] And, in his letter to Juncker, Lew argued that the investigations could "undermine the well-established basis

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Such a change in course, which has required the Commission to second-guess Member State income tax determinations, was an unforeseeable departure from the status quo.").

[301] *See Bipartisan Senate Finance Committee Letter*, *supra* note 263, at 1 ("four of the five investigations of company-specific tax rulings, and nearly all of the amounts at stake, involve U.S. companies"). The Commission later announced a case against Belgium's excess profits regime, which involved mostly European companies. *Belgian Excess Profits*, *supra* note 159.

[302] Testimony of Itai Grinberg, Associate Professor, Georgetown University Law Center, Before the Ways and Means Hearing on the Global Tax Environment (Feb. 24, 2016), at 4 (suggesting that Congress invoke I.R.C. § 891, a statute that has never been used since its enactment in the 1930s, which allows the President to double taxes on U.S.-source income flowing to nationals of a state that discriminates in taxing Americans).

[303] *See Bipartisan Senate Finance Committee Letter*, *supra* note 263, at 2.

[304] Sheppard, *supra* note 19, at 16.

[305] Lew Letter to Juncker, *supra* note 222, at 2.

[306] J.P. Finet, *European Commission Denies Discrimination Against U.S. Companies*, TAX NOTES INT'L (Feb. 12, 2016).

[307] *Bipartisan Senate Finance Committee Letter*, *supra* note 263, at 1 (warning of the Commission's pursuit of a "reform agenda" through state aid). *See also* TREASURY WHITE PAPER, *supra* note 16, at 17 (arguing that the Commission was "establishing a competing EU-only arm's length principle that is not tied to the global consensus embodied in the OECD TP Guidelines").

of mutual cooperation and respect that many countries have worked so hard to develop and preserve."[308]

The dispute between the United States and the Commission is not simply over how much tax Apple should pay Ireland. The Commission's Apple decision directly impacts how much tax Apple ultimately will pay in the United States, because the United States likely will credit against Apple's U.S. tax the recovery that Apple pays to Ireland. For this reason, the United States sought, but was denied, the opportunity to intervene in the *Apple* appeal.[309]

It would be both unreasonable and counterproductive to expect the Commission to place too much weight on these protests by the United States and its taxpayers. Beneficiaries of even sweetheart rulings can be expected to oppose state-aid enforcement, even when such enforcement hews closely to the traditional interpretation of selectivity. If anything, drawing the ire of the United States and multinationals away from individual Member States (and towards the Commission) is a salutary effect of anti-abuse enforcement at the EU level.[310]

While it may be unreasonable to expect the United States and U.S. multinationals to happily acquiesce to Commission state-aid decisions, that criticisms from U.S. officials emphasized the Commission's departure from past practice, and particularly its departure from the domestic-law-reference base, is significant. Similarly, leaders of major U.S. businesses stressed the Commission's departure from domestic standards, noting that "[t]o reach its decisions, the [Commission] relies on its own vision of the appropriate tax law rather than national laws and historically rooted international and OECD principles."[311] In contrast, reliance on a domestic-law reference base would seem to generate fewer conflicts with the United States and other third countries that negotiated tax treaties with EU Member States in light of specific domestic laws operable at the time of the tax treaty negotiation.

Since the 1920s, the tax jurisdictions of the world have resolved international income tax problems mostly cooperatively (although not always successfully) through bilateral tax treaties and with hard and soft law instruments that emphasize the importance of legal certainty to

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[308] Lew Letter to Juncker, *supra* note 222, at 1.

[309] Order of the General Court in Case T-892/16, Apple v. Commission, ECLI:EU:T:2017:925 (denied because the United States could now show harm).

[310] *See* Shaviro, *supra* note 20, at 1075-1078 (weighing the benefits and burdens to the United States and EU of strict EU state-aid enforcement).

[311] Business Roundtable Letter to Merkel, *supra* note 180, at 2. *See also* references at notes 263 to 266.

facilitate cross-border investment.[312] In addition to creating significant legal uncertainty, aggressive Commission enforcement of state aid could undermine international efforts to curb corporate-tax avoidance by creating conflicting standards or by antagonizing important players like the United States.

Instead of applying its own normative standards in state aid cases, the Commission can combat sweetheart rulings and other harmful tax practices while hewing to the traditional conception of selectivity as deviations from the domestic law reference base. The Commission could even position the traditional selectivity approach as consistent with international soft-law projects to combat harmful tax competition, like that undertaken as part of BEPS.

VI. Conclusions

The state-aid rules are a powerful mechanism for controlling state regulation and taxes, one unconstrained by ordinary notions of res judicata[313] or stare decisis.[314] Signaling the growing importance of state-aid law to the U.S. audience, in the last year, periodicals as diverse as *Tax Notes* and *The New York Times* ran front-page stories about the European Commission's investigation of Apple and other multinationals for tax avoidance.[315] This Article argued that the Commission is charting a dangerous new course in state-aid enforcement, and the upcoming appeals to the EU courts—especially in *Apple*—provide an important opportunity for the Court of Justice to limit the Commission's discretion.

In anticipation of those appeals, this Article introduced American readers to state aid, elucidated its values, provided economic and political-process justifications for its traditional selectivity requirement, and argued that in the recent cases involving U.S. multinationals the Commission has

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[312] 2017 OECD TRANSFER PRICING GUIDELINES, *supra* note 204.

[313] *See* QUIGLEY, *supra* note 20, at 762-3 (noting that the Commission can fix its analysis in cases where its state-aid decision was judicially annulled, thereby reinstating its state-aid decision without the need for a new investigation).

[314] *See, e.g., Starbucks*, *supra* note 110, at ¶ 239 ("the Commission… is not bound by its decisional-practice. Each potential aid measure must be assessed on the basis of its own merits under the objective criteria of Article 107(1) of the Treaty, so that even if a contrary decisional practice were shown to exist, that could not affect the findings of the present decision.").

[315] Teri Sprackland, *Person of the Year: Margrethe Vestager -- Guardian at the Gates of Europe*, 85 TAX NOTES INT'L 7 (2017). *Tax Notes* is essential reading for U.S. tax practitioners. *See* James Kanter & Mark Scott, Apple Owes $14.B in Back Taxes to Ireland, E.U. Says, NY TIMES (Aug 30, 2016). *See also* Natalia Drozdak & Sam Schechner, After Apple, Europe Goes After Amazon for Unpaid Taxes, Wall St. J. Oct. 3, 2017).

sought to fundamentally redefine selectivity in a manner that would arrogate to the Commission tax policymaking powers that the TFEU specifically reserves to the Member States. The Commission's actions ignited a major dispute with the United States, and even large, high-tax EU Member States that could be expected to benefit from state-aid actions against the EU's smaller, low-tax states have begun to express doubts about the Commission's expansive new approach.

This Article generates prescriptions for the EU courts. First, in the pending appeals involving U.S. multinationals, the EU courts should reject the Commission's sui-generis arm's-length standard in favor the Member State's own domestic-law income allocation rules.

Second, and more generally, the EU courts should reject the Commission's attempts in recent state-aid decisions to impose its normative views of the proper tax base on the Member States. In short, the EU courts should reaffirm the importance of the traditional selectivity analysis with its domestic-law reference base. The state-aid prohibition does not aim for equal treatment of all enterprises no matter what. Nor does it aim to ensure that Member State policies adhere to particular tax policies. Instead, the state-aid rules prevent states from deviating from their own law to convey benefits to specific enterprises. The EU courts therefore should reject the Commission's attempt to narrow or redefine selectivity as deviation from a normative reference base. Selectivity serves a vital role: it forces states to internalize costs of policies that create cross-border negative externalities. At the same time, it prevents the Commission from second-guessing basic Member State policy decisions. As a result, it strikes an appropriate, if imperfect, balance between free-market and policy-diversity goals.

The state-aid saga even contains lessons for the United States: if the United States does not tax its own multinationals on income earned in Europe, the Commission may fill the void, directing EU Member States to tax U.S. multinationals on income that would be more properly allocated to the United States.