



# Euro Tax Flash from KPMG's EU Tax Centre

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## Advocate General opinion on Irish transfer pricing rulings

**[CJEU – State Aid – Ireland – Transfer pricing ruling – Arm's length principle – Advantage – Selectivity](#)**

On November 9, 2023, Advocate General (AG) Giovanni Pitruzzella of the Court of Justice of the European Union (CJEU) rendered his [opinion](#) in case C-465/20 P. The case concerns two transfer pricing rulings issued by the Irish tax authorities in favor of two companies incorporated in Ireland, but tax resident in a different jurisdiction.

The AG concluded that the General Court committed a series of errors in law when it found that the European Commission (the Commission or the EC) had not shown to the requisite legal standard that the intellectual property (IP) held by the two plaintiffs was attributable to their Irish permanent establishments. The AG also took the view that the General Court erred in finding that the EC had not proven the methodological errors based on which the latter had concluded that the tax rulings were vitiated. Consequently, the AG recommended the CJEU to set aside the judgment and to refer the case back to the General Court for a new decision on the merits.

### Background

#### *The European Commission's Decision*

On December 19, 2016, the Commission issued a [decision](#) concerning two transfer pricing rulings granted by Ireland in 1991 and 2007 in favor of two companies incorporated in Ireland, but tax resident in a third country (the Decision). In short, the rulings endorsed the profit allocation methods related to the trading activity of the Irish branches of the two entities concerned. Among others, under the rulings certain IP licenses should be allocated for tax purposes outside of Ireland, i.e. to the head-offices of the two Irish branches rather than to the Irish branches themselves.

In the EC's view, the two rulings constituted unlawful State aid, incompatible with the EU internal market. According to the Commission, the Irish tax authorities accepted a profit allocation which diminished the tax base in Ireland, thus leading to a selective advantage granted to the plaintiffs. In a first line of reasoning, the Commission disagreed with the allocation of relevant IP outside of Ireland, which, in its view, led to those companies' annual taxable profits departing from a reliable approximation of a market-based outcome in line with the arm's length principle.

In a subsidiary line of reasoning, the EC explored a scenario where the Irish authorities were correct in their allocation of the IP outside of Ireland. In the Commission's view, the outcome was the same under this alternative scenario, as the functions exercised by the Irish branches would have required a greater attribution of profits to the Irish branches. In this respect, the EC identified three alleged erroneous methodological choices: the selection of the Irish branches as 'tested parties', the choice of the operating costs as profit level indicators and the levels of return accepted by the tax authorities.

Based on the above, the EC ordered Ireland to recover State aid amounting to approximately EUR 13 billion (plus interest). Both the taxpayers and Ireland appealed the EC's decision in front of the General Court of the EU (the General Court) – see EuroTaxFlash [Issue 307](#).

### *The General Court's Decision.*

On July 15, 2020, the General Court issued its [judgment](#) (joint cases T-778/16 and T-892/16) with respect to the appeals.

With respect the Commissions' primary line of reasoning, the General Court ruled that the EC, in its Decision, did not provide for sufficient proof for establishing a selective advantage under the State aid rules. According to the General Court, the EC incorrectly concluded that the Irish authorities granted an advantage to the Irish branches by a misallocation of the IP. In this respect, the EC should have demonstrated the value of income generated through the activities at the Irish branches rather than concentrating on the functions being performed outside of Ireland (the 'exclusion' approach). The General Court concluded that, materially, the Irish branches performed supportive activities, which would not justify the allocation of IP to those PEs. Among others, the General Court supported this conclusion by conducting its own assessment of the facts, which included a comparison of the functions undertaken by the Irish branches to those performed by the non-resident parent entity of the two plaintiffs (the Parent). The General Court also held that the Commission did not provide sufficient evidence supporting the conclusion that the IP should have been allocated to the Irish branches – see E-news [Issue 120](#).

With respect to the EC's subsidiary line of reasoning, the General Court took the view that the Commission did not succeed in demonstrating methodological errors in the tax rulings under dispute, which would have led to a reduction in the plaintiffs' chargeable profits in Ireland. In this respect, the General Court held that the existing inconsistencies identified by the EC were not sufficient to constitute a selective advantage for the purposes of Article 107 (1) of the Treaty on the Functioning of the European Union (TFEU).

However, the General Court endorsed the Commission's assessments of normal taxation under the Irish tax law, having regard to the tools developed within the OECD, such as the arm's length principle.

The EC appealed the judgment of the General Court in front of the CJEU.

### **The European Commission's appeal**

The Commission's appeal was based on two lines of reasoning, each divided into three parts.

The first ground of appeal concerned the General Court's criticism regarding the EC's primary line of reasoning, as follows:

- *application of an exclusion approach*: in the first part of its first ground of appeal, the EC submitted that the General Court misinterpreted the Commission's initial Decision. Specifically, the Commission pleaded that the General Court incorrectly understood that the EC allocated the IP to the Irish branches solely based on the lack of employees and physical presence in the head offices (instead of conducting a functional analysis). The EC also submitted that the General Court's decision was vitiated by contradictions concerning whether the IP allocation was based on a functional analysis or not.
- *relevance of functions carried out by the Parent*: in the second part of the first ground of appeal, the Commission submitted that, by using the functions performed by the Parent as the basis of comparison (rather than with those carried out by the head offices), the General Court violated the separate entity approach and the arm's length principle on which the relevant Irish legislation is based, therefore infringing Article 107(1) of the TFEU. In the alternative, the EC submitted that the infringement of the arm's length principle and of the separate entity approach constituted a manifest distortion of national law. The EC also asserted that the General Court committed a procedural irregularity by relying on inadmissible evidence.
- *assessment of activities carried out by the head offices*: in the third part of the first ground of appeal, the EC challenged more specifically the General Court's assessment of activities carried out by the plaintiffs' head office. Among its arguments, the Commission complained that the General Court imposed on it a burden of proof which was impossible to discharge.

The second ground of appeal was directed against the part of that judgment in which the General Court overturned the Commissions' subsidiary line of reasoning, as follows:

- *standard of proof*: in the first part of the second ground of appeal, the EC submitted that the General Court erred in law when applying the rules on the standard of proof that the EC needs to comply with when examining the existence of a selective advantage under Article 107(1) TFEU.
- *reliance on arguments not raised at first instance*: in the second part of the second ground of appeal, the EC submitted that the General Court committed a breach of procedure, by rejecting the EC's subsidiary line of reasoning based on arguments not raised by the plaintiffs or by Ireland in their applications at first instance.
- *methodological errors*: in the third part of the second ground of appeal, the EC submitted that the General Court misrepresented the Decision and infringed Article 107(1) TFEU and/or distorted the Irish law in concluding that the Decision had not established the existence of an advantage. Specifically, the Commission took the view that the General Court made three pricing methodological errors with respect to: i) the analysis related to the choice of the Irish branches as 'tested parties'; ii) the choice of the operating costs as the profit level indicator; and iii) the levels of return accepted by the transfer pricing rulings in place.

## **The Advocate General's opinion**

*Primary line of reasoning: allocation of relevant IP outside Ireland*

### Application of an exclusion approach

The AG upheld the Commission's plea that the General Court misinterpreted the EC's approach to analyzing the allocation of IP and related profits. In the AG's view, the General Court incorrectly maintained that the

Commission applied an 'exclusion'<sup>1</sup> approach based on the absence of employees and physical presence in the head offices. In this respect, the AG highlighted that the Commission had also applied a legal test consisting in a comparison of the functions, assets, and risks between the head offices and the Irish branches, respectively, with regard to the IP licences. As such, according to the AG and contrary to the General Court's views, the EC's conclusion that the IP licences and profits should be allocated to the Irish branches was based on two distinct findings: i) the lack of functions and risks assumed by the head offices, but also on the ii) the numerous and central functions performed by the Irish branches.

The AG also upheld the Commission's plea that the judgment under appeal was vitiated by contradictions. As such, on the one hand, the General Court held that the EC failed to perform a functional analysis to substantiate the allocation of the IP licences. However, on the other hand, subsequent paragraphs of the judgment contradicted this claim by emphasizing that the Commission had indeed identified the functions performed by the Irish branches.

Based on the two arguments above, the AG concluded that the first part of the first ground of appeal should be upheld.

#### Relevance of functions carried out by the Parent

The AG also upheld the Commission's plea that the General Court erred in law by implicitly accepting the relevance of the functions performed by the Parent for the purpose of determining the taxable profits of the plaintiffs in Ireland. In this respect, the AG endorsed the EC's understanding of the General Court's findings in the judgment under appeal concerning the legal test deemed applicable for attributing profits to the Irish branches. Specifically, such attribution should be based on a functional analysis confined to the activities conducted by the Irish branches and their respective head offices.

The General Court however deviated from this approach and compared the functions and risks undertaken by the Irish branches with the ones undertaken by a separate legal entity (i.e. the Parent). This deviation, in the AG's view, amounted to using a different legal standard than what Irish law prescribed.

The AG also rejected the plea submitted by Ireland and the plaintiffs, asserting that even if the General Court did take into account the functions of the Parent, the EC's complaint was ineffective. In their view, the General Court's conclusion was made in the context of an analysis of the activities of the Irish branches and the head offices, indicating that the functions performed by the former were 'routine' (thus insufficient to justify the allocation of IP licences). However, the AG held that, whilst the General Court did consider the decision-making role played by the head offices, it did not find that the head offices actually participated in the strategic decisions taken by the Parent or were actively involved in implementing them or in actively managing the IP licences.

#### Assessment of activities carried out by the head offices

Among others, the AG assessed the EC's complaint against the General Court's conclusion that the absence from the evidence examined by the EC (i.e. minutes of board minutes provided as evidence) of specific information on decisions taken by the board of directors, does not mean that those decisions were not taken. The AG expressed reservations regarding the GC's interpretation. Furthermore, the AG noted that it is an unjustifiably excessive burden on the Commission to prove the existence of negative facts which can only be presumed.

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<sup>1</sup> The 'exclusion approach' presumed that the EC examined the overall profits derived by the non-resident companies and, to the extent that those profits could not be allocated to other parts of those entities, were allocated by default to the Irish branches.

The AG disputed the Commission's interpretation of the paragraphs of the judgment that it raised complaints against in this part of the plea. The AG therefore concluded that the third part of the first ground of appeal is in part admissible and well founded.

In light of the overall assessment of the EC's first ground of appeal, the AG concluded that it was well founded and should be upheld.

### ***Second line of reasoning: alleged transfer pricing methodological errors in the allocation of profits to the Irish branches***

#### Standard of proof

With respect to the EC's subsidiary line of reasoning, the AG first focused on the standard of proof. The AG recalled that, under settled case-law, it was the responsibility of the EC to demonstrate the existence of State aid and the associated conditions outlined in Article 107 (1) of the TFEU – including that the condition of granting an advantage was fulfilled. The AG noted that the EC's conclusion was based on specific errors in the rulings that, in the Commission's opinion, vitiated the profit allocation. In the AG's view, it could not be ruled out that fundamental errors in determining the transfer pricing methodology applicable could be manifestly capable of reducing the tax burden as compared to the normal taxation rules. In the AG's view, the EC may be entitled to rely on proof of the existence of such an error and on the fact that Ireland failed to prove that it had no impact on whether the profits were computed based on the arm's length principle. Therefore, in the AG's view, the General Court incorrectly assessed the standard of proof.

#### Reliance on arguments not raised at first instance and methodological errors

Nevertheless, in the AG's view, the error in assessing the standard of proof would not affect the General Court's conclusions if the Commission's findings concerning transfer pricing methodological errors and reliance on arguments not raised previously were unfounded. Therefore, the AG continued by analyzing the EC's pleas on the transfer pricing aspects.

First, the AG disagreed with the General Court's finding that the Irish branches were correctly selected as the 'tested parties' for the purposes of applying the Transactional Net Margin Method (TNMM). The AG recalled that, in his view, the General Court made an error by comparing the functions performed by the Irish branches with those of a distinct legal entity other than the head offices, i.e. the Parent. In the AG's view, this error also affected the assessment which led the General Court to approve the choice of the Irish branches as 'tested parties'. The AG also held that, in line with the 2010 version of the OECD guidelines, the choice of the tested party is a fundamental step in the application of the TNMM, significantly impacting the reliability of the analysis.

The AG also rejected the General Court's decision to set aside the EC's findings regarding the choice of profit level indicators. The EC had argued in the Decision that, even if the selection of the Irish branches as tested parties was correct, using the plaintiffs' operating costs for the transfer pricing assessment produced a result that did not align with the arm's length principle. In the AG's view, the General Court did not sufficiently consider the EC's analysis and again infringed the separate entity approach (by comparing the functions of the Irish branches to those of the Parent).

Lastly, the AG upheld the EC's appeal related to the levels of return of the Irish branches accepted in the tax rulings.

Considering the above, the AG concluded that, taking together the EC's second and third parts of the second ground of appeal, the General Court erred in the definition of the standard of proof incumbent on the Commission. The AG also found that the General Court made a series of errors of law in the analysis which led it to conclude that the Commission had not demonstrated the methodological errors identified in the context of its

subsidiary line of reasoning. Consequently, the AG took the view that the second ground of appeal must be considered well founded in its entirety.

### **AG's conclusions**

The AG concluded that the appeal of the EC was well founded and that the judgment of the General Court should be set aside in its entirety. Since the CJEU would not be in a position to give a final judgment on the actions at first instance, the AG recommended that the CJEU refers the case back to the General Court for a new assessment.

### **ETC Comment**

The AG opinion in the case at hand is the latest in a string of cases related to EC's State aid investigations concerning tax rulings granted by Member States

A noteworthy point is highlighted in the AG's introductory comments where the AG argued that State aid rules should not be employed as a means to achieve covert tax harmonization in situations where political obstacles exist or to address harmful tax competition. Furthermore, in the AG's view, exploiting the advantages of disparities between tax systems does not constitute the granting of State aid and tax competition between Member States is not prohibited per se. Nevertheless, the AG took the view that the Commission must have the ability to investigate whether a Member State, through a tax measure such as a tax ruling, confers a selective advantage upon a specific business. In certain cases, according to the AG, such tax rulings might grant an unfair advantage over competitors, potentially undermining competition, innovation, and consumer interests.

It is interesting to note that the AG specifically pointed out that, in his view, the General Court's findings on the application of the arm's length principle in the context of the relevant Irish legislation are fully in line with the CJEU's judgment in joined cases C 885/19 P and C 898/19 P (see EuroTaxFlash [Issue 492](#)), where the Court held that the Commission is entitled to rely on the arm's length principle only if and to the extent that its application is provided for by the tax legislation of the Member State concerned. The AG further noted that the General Court expressly rejected the Commission's argument that Article 107(1) TFEU gives rise to a freestanding obligation for the Member States to apply that principle and that the application of the arm's length principle in this case is based on the Irish tax rules.

It should be noted that AG opinions are not binding on the CJEU. Therefore, it remains to be seen whether the CJEU will follow the AG's recommendation to refer the case back to the General Court for a new decision on the merits.

Should you have any queries, please do not hesitate to contact [KPMG's EU Tax Centre](#), or, as appropriate, your local KPMG tax advisor.



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