KPMG Meijburg & Co Tax Lawyers

General Court examines the compatibility of rulings granted by Ireland, Luxembourg and the Netherlands with EU State aid rules

Following multiple State aid investigations launched by the European Commission, the General Court of the European Union was asked to examine whether the advance transfer pricing agreements granted by Ireland, Luxembourg and the Netherlands were compatible with EU law. In the case involving the Netherlands, the Court ruled on September 24, 2019 that the Commission's decision should be annulled, but upheld the Commission's findings in the case involving Luxembourg. As regards the Irish case, during a hearing that took place on September 17 and 18, 2019 the Court requested the Commission, Ireland and the taxpayer concerned to clarify their arguments.

Background

Tax rulings have increasingly come under public scrutiny as their investigation became part of what the Commission refers to as a wider strategy towards tax transparency and fair taxation. This led to inquiries into the compatibility of the tax ruling practices of certain Member States with EU State aid law, starting in June 2013. Under EU law (Article 108 of the Treaty on the Functioning of the EU), the European Commission is obliged to review whether Member States give selected companies preferential treatment that is incompatible with applicable State aid rules. Broadly speaking, aid is incompatible with EU law if it distorts competition by, for example, favoring certain undertakings and thus affecting trade between Member States.

In December 2014, the Commission extended the information inquiry into tax rulings issued by all Member States since January 1, 2010, and in June 2015 requested 15 Member States to provide detailed information on some of their rulings. Following a series of in-depth investigations, the Commission concluded that Belgium, Luxembourg and the Netherlands, and more recently Ireland and again Luxembourg (click here and here), have granted selective tax advantages that are illegal under EU State aid rules.

In most cases, the Member States and taxpayers involved decided to appeal the European Commission's decisions before the General Court. On February 14, 2019 the latter ruled that the Commission had failed to demonstrate the existence of an aid scheme in the Belgian "Excess profit" tax ruling regime case and annulled the decision in its entirety. The Court has now begun examining the compatibility with EU State aid law, of individual tax rulings delivered by Ireland, Luxembourg and the Netherlands.

EU General Court decision in the Luxembourg rulings case

On October 21, 2015 the European Commission issued a final decision confirming that the transfer pricing ruling granted by Luxembourg to an Italian car manufacturing group constituted illegal State aid. In the Commission's opinion, the alleged State aid arises from the method laid down in the ruling for the calculation of the taxable basis of a Luxembourg subsidiary performing intra-group financing and treasury activities. According to the Commission, the ruling endorsed "artificial and complex methods" that do not "reflect economic reality" and thereby granted a selective and unfair competitive advantage to those companies.

Following appeals filed by the taxpayer concerned (T-759/15) and Luxembourg (T-755/15) with the General Court, the latter decided to join the cases and issued its

decision on September 24, 2019. The Court first confirmed that the Commission was entitled to apply the arm's length principle to ascertain whether the ruling under review granted an advantage to its beneficiary. This is because Luxembourg tax law provides that both integrated and stand-alone businesses are subject to corporate income tax under the same conditions. The Court then examined whether the adjustments to the taxable base endorsed by the ruling were justified and concluded that the amount of capital to be remunerated at the level of the Luxembourg subsidiary was underestimated, thus providing an advantage to the group. In this respect, the Court confirmed that the fact that the corresponding advantage would be taxed in Italy at the level of another group entity is irrelevant. Finally, the Court endorsed the Commission's findings that the contested ruling gave a selective and unjustified advantage to the taxpayer, which is likely to distort competition within the EU.

As a consequence, the General Court upheld the Commission's findings that Luxembourg granted illegal State aid to the ruling's beneficiary.

EU General Court decision in the Netherlands rulings case

On October 21, 2015 the European Commission issued a final decision confirming that the transfer pricing ruling granted by the Netherlands to a US coffee manufacturing group constituted illegal State aid. In the Commission's opinion, the alleged State aid arises from the method laid down in the ruling for the calculation of the taxable base of a Dutch subsidiary performing manufacturing activities. The Commission expressed doubts as to the Dutch company's classification as a low-risk toll manufacturer and as to the fact that the level of royalties paid did not seem to be linked to the value of the relevant intellectual property.

Following appeals filed by the taxpayer concerned (T-736/16) and the Netherlands (T-760/15) with the General Court, the latter decided to join the cases and issued its decision on September 24, 2019. As in the Luxembourg case, the Court first observed that the Commission was entitled to apply the arm's length principle. However, the Commission failed to convincingly demonstrate that the methodological errors identified in the contested rulings (method chosen, estimate of the level of royalties paid and the price of unroasted coffee beans) did not allow a reliable approximation of an arm's length outcome. In particular, the Commission failed to demonstrate that the application of the rulings resulted in an inappropriate reduction of the tax payable by the Dutch subsidiary. The Court therefore concluded that the contested rulings did not give an undue advantage to the taxpayer.

As a consequence, the General Court annulled the Commission's decision that the Netherlands granted illegal State aid to the ruling's beneficiaries.

Hearings in the Irish rulings case

On August 30, 2016 the European Commission issued a final decision confirming that two transfer pricing rulings granted by Ireland to a US group constituted illegal State aid. In the Commission's opinion, the rulings endorsed a way to establish the taxable profits for two Irish incorporated group companies, which did not correspond to economic reality as almost all sales profits recorded by these companies were internally

attributed to each company's head office and not to their respective Irish branches. The profits allocated to the head offices were not subject to tax in any country under specific provisions of Irish tax law, which are no longer in force. Both the taxpayer concerned and Ireland appealed the Commission's decision before the General Court.

During the hearing, which took place on September 17 and 18, 2019, both parties argued in particular that State aid law is not appropriate for addressing a case that fundamentally relates to a mismatch in international tax law and that Irish law was applied properly, as supported by expert evidence. They further explained that the branches in Ireland only carried out routine functions and there were no intellectual property-related activities in Ireland. Therefore, the very substantial profits deriving from this intellectual property were not attributable to the Irish branches. Finally they contended that the European Commission misapplied the arm's length principle, as the latter is not part of EU or Irish law.

After hearing the parties' arguments, the Court requested clarification of a number of matters, including the European Commission's legal grounds that there is State aid. The Court also challenged the multiple lines of argumentation presented and how these arguments changed during the various stages of the proceedings. It also questioned the lack of factual evidence presented by the Commission on the existence of an advantage. The Court also disputed the lack of documentation supporting the discussions between the Irish tax authorities and the taxpayer, and the need for a ruling if the latter did not depart from Irish law.

Our observations

Both the Luxembourg and Dutch governments have issued statements on the General Court's decisions, the former recalling the numerous reforms implemented by Luxembourg in recent years and the latter welcoming the findings of the General Court that the Netherlands did not infringe EU rules. It is now open to both Luxembourg and the Italian group on the one hand, and to the Commission on the other to appeal the respective decisions before the Court of Justice of the European Union.

Although the outcome of the decisions in both cases differs greatly, there are a number of interesting conclusions that can be drawn from the judgments, which may also shed some light on the other cases currently pending before the General Court as well as the cases currently under investigation by the European Commission.

Arm's length principle under Article 107(1) TFEU

First, it follows from the judgments that the General Court is of the opinion that the Commission was right in assessing whether the conditions agreed upon under the rulings approximated the conditions that would have been agreed upon under market conditions. It is important to note that this conclusion appears to be based on the observation of the General Court that, if national tax legislation does not make a distinction between integrated and non-integrated companies, such legislation apparently aims to tax the profits resulting from the economic activities of integrated companies as if such profits were generated under market conditions. This approach

seems to imply that the presence or absence of an arm's length principle in domestic legislation is of no importance.

Importance of OECD transfer pricing guidelines

As regards the interpretation and application of the arm's length principle it follows from the judgments that the General Court considers the OECD transfer pricing guidelines to have real practical significance in the interpretation of issues relating to transfer pricing. Furthermore, the Commission must take into account the fact that the arm's length principle enables it to verify whether the transfer pricing accepted by a Member State corresponds to a reliable approximation of a market-based outcome, but that an advantage can only be identified if the variation between the two comparables goes beyond the inaccuracies inherent in the methodology used to obtain that approximation.

No obligation to use a CUP analysis instead of a TNMM analysis

As regards the Commission's argument that, where available, tax authorities should base a tax ruling on a direct transfer pricing methodology such as the CUP method, rather than on an indirect method such as a TNMM approach, the General Court found that the OECD guidelines do not provide for such a strict interpretation. It is important to note that in this respect the General Court referred explicitly to the Dutch transfer pricing decree (supported by the 1995 OECD TP guidelines), on the basis of which the taxpayer is free to choose a transfer pricing method, provided that the method chosen leads to an arm's length outcome and the Dutch tax authorities must always conduct a transfer pricing audit from the perspective of the method adopted by the taxpayer at the date of the transaction.

The Commission's use of evidence that was not available when the APA was concluded

Another important observation is that the General Court is of the opinion that the Commission is required to refrain from assessments based on a situation subsequent to the adoption of the APA. That is to say, if the decision, as in the Starbucks case, only relates to the APA, but not to the final tax assessments imposed on the basis of that APA. Hence, information and/or documentation of a later date cannot be used to substantiate the position that illegal State aid has been granted.

Burden of proof

It also follows from the judgments that the Commission has quite a heavy burden of proof, in the sense that the Commission is required to conduct a diligent and impartial examination of the measures at issue, so that it has the most complete and reliable information possible at its disposal. Outright inconsistencies or errors, such as the inability of the Commission to replicate its own comparability analysis, do not benefit the Commission's analysis.

The Commission will probably appeal the decision of the General Court; the Grand-Duchy of Luxembourg and Fiat are also expected to file appeals. Hence, it remains to be seen whether the Court of Justice of the European Union will confirm the

judgments of the General Court and whether these will thus have a bearing on the other cases.

Should you have any queries, please do not hesitate to contact your Meijburg & Co tax advisor.

Meijburg & Co
September 2019

The information contained in this memorandum is of a general nature and does not address the specific circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.