KPMG Meijburg & Co Tax & Legal

CJEU annuls Commission decision on Luxembourg transfer pricing ruling

On November 8, 2022, the Court of Justice of the European Union (CJEU or the Court) gave its decision in the joined cases C-885/19 P and C-898/19 P. Both cases concern the validity of a decision issued by the European Commission (the "Decision"), which found a transfer pricing ruling granted by Luxembourg to be incompatible with EU State aid rules.

The case was first disputed in front of the General Court of the EU, which ruled in favor of the European Commission (Commission or the EC). In the appeal brought before it, the CJEU concluded that the General Court was wrong to confirm the Commission's approach to apply a version of the arm's length principle not codified in domestic law. Finding that the selectivity analysis was vitiated, the CJEU decided to set aside the General Court's judgement and to annul the Commission's Decision.

1. Background

On October 21, 2015 the European Commission issued a decision according to which 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 arose from the methodology outlined in the tax ruling regarding 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.

Appeals were filed by the taxpayer concerned (T-759/15) and Luxembourg (T-755/15) with the General Court, which decided to join the cases and issued its decision on September 24, 2019. The General Court confirmed that, when examining a fiscal measure granted to an integrated company, the Commission may compare the fiscal burden for that company with the fiscal burden resulting from the application of the normal tax rules of national law to a company carrying on its activities under market conditions, where national tax law does not make a distinction between integrated 'undertakings' and stand-alone 'undertakings' for the purposes of their liability to corporate income tax. The General Court agreed that the arm's length principle is a 'tool' that enables the EC to check whether the pricing of intra-group transactions accepted by the national authorities corresponds to pricing under market conditions to ascertain whether the ruling under review granted an advantage to its beneficiary.

The General Court was of the view that the use of the arm's length principle was permitted due to the fact that Luxembourg chose to tax the profits of both integrated and stand-alone businesses on the same terms, irrespective of whether or how that principle was codified in national law. As a result, the General Court upheld the Commission's findings that Luxembourg granted illegal State aid to the ruling's beneficiary.

Both the taxpayer involved in the proceedings and Ireland (supported by Luxembourg and the taxpayer) appealed the General Court's judgment to the CJEU. In the appeal brought forward by Ireland, the AG concluded that the previous ruling issued by the General Court infringed the provisions governing the division of competences between

the EU and the Member States. As a result, the AG recommended that the CJEU sets aside the judgment of the General Court, allows Ireland's appeal and annuls the Decision. On the other hand, the AG recommended that the appeal brought by the taxpayer in the case C-885/19 P should be dismissed.

2. The CJEU decision

The CJEU first recalled that the provisions of the Treaty on the Functioning of the European Union (TFEU) on monitoring State aid also cover areas where EU law is not harmonized, and that Member States must refrain from adopting measures that could represent State aid incompatible with the internal market. The Court then referred to its previous case-law in summarizing the steps required for a national measure to qualify as illegal 'State aid':

1. There must be an intervention by the State or through State resources
2. The intervention must be liable to affect trade
3. The intervention must confer a selective advantage on the beneficiary
4. It must distort or threaten to distort competition.

As regards the third step in particular – considering whether a selective advantage has been granted, the European Commission is tasked with (i) identifying the reference system, i.e. the ordinary tax system applicable in that Member State in a factually comparable situation (by reference to the objectives of that regime), and (ii) demonstrating that the disputed tax measure – in this case the tax ruling – is a derogation from that 'normal' system, and therefore represents a form of discrimination (either formally or in practice). The Court reminded that an error made in determining the reference system vitiates the entire selectivity analysis.

The CJEU further acknowledged that the Luxembourg law aims to identify a reliable approximation of the market price, which corresponds, in general terms, to that of the arm's length principle. Nevertheless, based on settled case-law, in the absence of harmonization in EU law, each Member State has exclusive competence in the field of direct taxation to determine at their own discretion the characteristics of their domestic tax system. Therefore, only the national law applicable in the Member State concerned must be considered when identifying the reference framework for the purposes of determining the existence of a selective advantage.

According to the Court, even where there is consensus at international level (e.g. in the OECD) that transactions between related parties must be assessed for tax purposes as if they had been concluded between economically independent companies, such rules can only be taken into account when examining the existence of a selective tax advantage where the national tax system makes explicit reference to them.

The Court further noted that by upholding the Commission's approach to apply a version of the arm's length principle based on the perceived intent of the Luxembourg legislation, and not as codified in domestic law, the General Court infringed the TFEU provisions relating to the adoption by the EU of measures in the field of direct taxation.

The Court also noted that when the Commission takes note that a Member State has chosen to apply the arm's length principle when determining the transfer prices applied

by companies that are part of a group, it must be able to prove that the application of national law is inconsistent with the objective of non-discrimination, by "systematically leading to an undervaluation of the transfer prices applicable to integrated companies or to certain of them, such as finance companies, as compared to market prices for comparable transactions carried out by non-integrated companies."

The Court noted that, in this case, the Commission's analytical framework did not take into account all the relevant parameters of the arm's length principle under Luxembourg law. The Commission therefore failed to demonstrate systematic discrimination.

Considering the above, the CJEU decided to set aside the General Court's decision and to annul the Commission's Decision.

3. Our comment

The CJEU's decision brings key clarifications with regard to the choice of a reference system in transfer pricing State aid reviews. The CJEU specifically noted that it cannot be inferred from its previous case-law that it intended to establish an autonomous arm's length principle to be applied in State aid investigations independently of how the principle was codified in domestic law.

The ruling also clarifies the role of the OECD's arm's length principle and guidelines in the context of State aid reviews. When determining the reference system for the purposes of the selectivity analysis, the European Commission must therefore consider the legislative choices of a Member State as regards the arm's length principle and its implementation in domestic law, rather than the Commission's interpretation of that principle, whether based on OECD principles or otherwise.

Several State aid cases related to transfer pricing arrangements are currently pending before the CJEU decision. Although not conclusive, the Court's decision in C-885/19 P and C-898/19 P may provide some indication on the potential outcome of these pending cases.

Please do not hesitate to contact us if you have any questions about the above. Meijburg's advisors would be pleased to use their expertise to help you.

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