Tax controversy series

Administrative court of appeal judgment on US branch

On 30 January 2024, the Luxembourg administrative Court of Appeal *(Cour administrative, 30 janvier 2024, n°49145C)* confirmed the decision rendered by the Luxembourg administrative court of first instance *(Tribunal administratif, 26 mai 2023, n°45030)* to deny the status of permanent establishment ("PE") to the United States of America ("US") branch of a Luxembourg resident company (or the taxpayer) given the facts and circumstances of the case. It also rejected the taxpayer's argument based on a violation of the principle of legitimate expectation, allegedly established by several elements including one tax assessment issued in 2013.

Summary of the case

In 2013, the Luxembourg company established a branch in the US with the intention to perform intra-group financing activities. A tax ruling request claiming the recognition of a PE in the US was filed to the Luxembourg tax authorities ("**LTA**") in the same year.

In September 2015, the LTA issued the tax assessment for 2013, which was in line with the tax return filed by the taxpayer[1]. Despite the fact that, at the time, the company had not received any response from the LTA concerning the granting of the tax ruling, the 2013 tax return was nonetheless prepared assuming the US branch could be regarded as a PE for Luxembourg tax purposes. Consequently, a tax balance sheet taking into account the assumed US PE was attached in the annexes of the 2013 tax return.

On 22 December 2015, the LTA reached out to the company saying that no answer would be provided to the ruling request as the company had already received an assessment for the year 2013.

On 11 September 2019, the tax office issued final tax assessments for tax years 2014 to 2017 and, due to the lack of (deemed) relevant evidence to support its substance, denied the qualification of the US branch as a PE.

On 16 October 2019, the taxpayer submitted its claim to the director of the LTA, who confirmed the position of the tax office. The director's decision was then referred to the Luxembourg administrative Court of first instance ("**the administrative tribunal**" or "**the tribunal**") by the taxpayer, which also rejected its claim on 26 May 2023. This ultimately led the taxpayer to lodge an appeal to the administrative Court of Appeal ("**the administrative Court of Appeal**" or "**the Court**").

Context of the decision

We were waiting for this judgment as we had the opportunity to discuss the decision rendered by the administrative tribunal in the first article of our tax controversy series[2]. Even though the administrative Court of Appeal's decision not to deviate from the position of the administrative tribunal does not really come as a surprise given the circumstances of the case, we believe the developments made by the administrative Court of Appeal regarding the legitimate expectation and legal certainty concepts may deserve further comments.

This principle arises from the European law, also, the right to rely on that principle presupposes that precise, unconditional, and consistent assurances, originating from authorized, reliable sources, have been given to the person concerned by the competent authorities of the European Union (**EU**). Based on this principle, tax authorities that have given assurances or made promises must be required to honor the expectations they have created for taxpayers. In the case at hand, the question arose whether the behavior of the LTA should be considered as sufficient to have built legitimate expectation for the taxpayer that its US branch would be respected as a PE for Luxembourg direct tax purposes. Two elements have been put forward by the taxpayer to sustain its argument.

The first one is based on publicly available information about the position taken by the LTA in a case presenting at first glance common features with its own situation, i.e. the recognition of a branch of a Luxembourg taxpayer in the US as a PE: *"The appellant intends to draw a parallel with the case of State aid involving the company (N) and the Grand Duchy of Luxembourg, while criticizing the first judges for not having taken a position with regard to its arguments based on this case. She concludes that nothing would allow the administration to treat her differently, even though she was in a known and usual situation. Although a great many finance branch structures had, in the past and at the time of her request for an advance ruling, obtained recognition by the authorities, her own refusal would raise questions, all the more so in the absence of a clear response from the authorities to her request."*[3]

Though the case in question has been anonymized in the judgment, there is little doubt that the parallel drawn by the appellant was between their case and the famous McDonald's case[4] – a situation in which the LTA not only granted a ruling to a Luxembourg subsidiary of the US group, but also successfully challenged a State aid investigation launched by the European Commission (which was publicly announced by the European Commission on 3 December 2015). In the McDonald's State aid investigation, the European Commission's experts finally reached their conclusion on 19 September 2018 – after an almost three-year investigation – that Luxembourg's tax treatment of McDonald's Europe Franchising did not violate the Luxembourg-United States Income and Capital Tax Treaty (1996)[5]. Based on the figures released by the European Commission in 2018, approximately 70 companies in Luxembourg benefited from the same tax treatment as McDonald's at that time[6].

Furthermore, it seems that in its supplementary memorandum, the appellant raised a second and additional argument to sustain its claim regarding the violation of the principle of legitimate expectation more related to its own situation: *"In this context, [the appellant] states that its request for an advance ruling would have been rejected in December 2015 on the grounds that the year 2013 had already been taxed previously, namely on 9 September 2015. However, the tax assessment for the 2013 financial year would have been issued in accordance with the tax return submitted to the tax authorities, accompanied by a tax balance sheet providing information precisely on the existence of the US financing branch."*[7]

Based on the decision of the Court (described in more detail in the section "Decision of the Court"), the position seems clear that, in absence of any advance tax ruling, a taxpayer should not take for granted methodologies previously accepted as the LTA may reject their application when it comes to future returns. This is not the first time that the administrative Court of Appeal has ruled that way[8]. This stance, however, ironically still raises many questions and uncertainties, in a context where the general principles of the law at stake are those of legitimate expectation and legal certainty.

We may only assume the rationale behind such a position would be not to bind the LTA to the assessments it issued in the past (notably in case of absence of review of previous tax returns). The administrative Court of Appeal's decision, however, also raises significant implications for the taxpayers. In the absence of any tax ruling, a tax assessment is generally the main document taxpayers rely on to have a certain level of legal certainty as to whether the methodologies applied are correct. A taxpayer may, in good faith, apply a specific tax treatment, and bolstered by the final tax assessment, continue to apply it for subsequent tax returns, only to be challenged years later by the LTA.

Regarding the tax returns, there is usually a definite number of items that should be reassessed on a regular basis (e.g. transfer pricing studies regarding intra-group transactions, the so-called comparable tax test in the Luxembourg participation exemption regime, etc.). However, it seems clear from the position of the courts that, from now on, taxpayers should systematically question every computation carried out in those returns, albeit unchallenged in the past. This road, if taken, is debatable as it contributes to further blurring the tax environment for taxpayers and increases their reporting obligations even more.

One may wonder whether this interpretation of the legitimate expectation concept made by Luxembourg courts is in line with the EU approach. On this matter, we can only encourage taxpayers to mitigate the risk of future challenges by the LTA by reaching out to their tax advisors to review the robustness of their transactions for direct tax purposes.

Decision of the Court

In short, the administrative Court of Appeal followed the administrative tribunal reasoning in all its findings, therefore ultimately reaching the same conclusion: that the taxpayer was unable to demonstrate with sufficiently hard evidence the reality of the branch it claimed to have in the US.

The Court (as already done by the tribunal of first instance in its decision) starts by reiterating the criteria to be fulfilled for a branch to be regarded as a PE under the double tax treaty signed with the US, namely:
- a place of business, i.e. a physical installation of some kind such as those listed by way of illustration in Article 5, paragraph 2 of the Convention
- this installation must be fixed, i.e. it must, on the one hand, have a link with a specific geographical point and, on the other, be characterized by a certain permanence
- the activity of the enterprise must have been carried out wholly or partly from or through this fixed place of business

In light of the above requirements, the Court thus reassesses the materiality of the evidence brought by the taxpayer and reaches the same conclusion as the tribunal of first instance:
- It observes that there are inconsistencies between the office agreement and the service agreement serving as evidence which subsequent explanations given by the taxpayer do not clarify. It follows that the Court is unable to determine the precise physical address of the branch.
- It underlines that the taxpayer fails to specifically explain the day-to-day activities of the alleged branch. Aside from the office agreement and the service agreement, both concluded with the head office, the Court notes that the taxpayer is unable to provide any other elements corroborating the activity of the branch. Going beyond the legal appearance those agreements were meant to create, the judges assert that their mere existence does not demonstrate their actual execution.
- The payments the branch was supposed to make as per the service agreement have not been executed.

The Court also rejects the legitimate expectation argument raised by the taxpayer. It rules that, even though the LTA did not challenge the existence of the PE when assessing the 2013 tax return, this did not create a legitimate expectation on which the taxpayer may rely. In other words, the 2013 tax assessment relates to the tax return of this specific year only and the taxpayer should not assume that it means that the PE was therefore effectively recognized by the tax office and that subsequent tax returns may not be rectified on that ground.

To summarize the facts at hand and the question that the Court had to answer regarding the principle of legitimate expectation of the appellant as we may infer them from what is mentioned in the Court decision:
- a practice and tax treatment largely spread on the market and accepted by the LTA at that time (70 cases found by the European Commission in 2018)
- taxpayers having obtained tax rulings from the LTA (such as McDonald's)
- the LTA combating the European Commission's view that this practice would be constitutive of a State aid
- a final tax assessment issued by the same LTA not challenging the PE treatment applied by the taxpayer in its corporate tax return for year 2013
- a ruling request finally rejected not on the grounds of its merits but on the fact that 2013 has already been (favorably) assessed by the same LTA (presumably having knowledge of the tax treatment applied when deciding on the ruling request)

was it legitimate for the appellant to expect that the LTA would treat their US branch as a PE for FY 2014 as they did for 2013?

The Court says no.

Recalling that the principle of legitimate expectation aims to protect the taxpayers against abrupt and unpredictable changes of position from the LTA, the Court emphasizes that this was not the case here, given that:
- the taxpayer did not benefit from any tax ruling confirming the qualification of the branch as a PE
- the taxpayer was, on top of that, informed by the LTA that it would not formally take a stance on the recognition of the existence of the US branch further to its ruling request

The Court also justifies its position based on the principle of annuality of taxation (*principe de l'annualité de l'impôt*) whereby the 2013 tax assessment issued being in line with the tax return as filed by the taxpayer does not imply the LTA would from now be bound to accept the existence of a US PE in future tax returns. In light of these considerations, the administrative Court of Appeal rules that the judges of first instance rightfully rejected the taxpayer's claim and therefore confirms its judgment denying the recognition of a US PE. As mentioned above, the outcome of the decision is not particularly surprising as it primarily underscores the importance of having robust documentation to evidence the substance of an alleged PE, given this is an element the LTA's radar systematically focuses on.

The most important and uncertain aspect however relates to the legitimate expectation notion which seems to no longer be an effective tool upon which taxpayers may rely from now on (in the absence of a ruling issued by LTA). Regarding tax assessments, the Court of Appeal made it clear: they may only provide insurance to taxpayers that their corresponding return will not be challenged, not that its content will be followed in future years. A change of legislation would be welcome to provide more legal certainty. When the interpretation of the general principles of the law of legitimate expectation and legal certainty creates more legal uncertainty, it suggests that there is something that might not work as intended by the (domestic or European) legislator, and that only the law may provide clarity.

Emilien LEBAS,
Partner,
International Tax, Tax controversy & dispute resolution leader

Valentine PLATEAU,
Assistant Manager, International Tax,

KPMG Luxembourg

1) In the first article of our tax controversy series (*E. Lebas, "Tax controversy series – Administrative court judgment on US branches", AGEFI Luxembourg, September 2023 p. 13)* concerning the judgment of the Luxembourg administrative Court of first instance *(Tribunal administratif, 26 mai 2023, n°45030)*, it was not clear whether such tax assessment was in line with the return filed. It is now confirmed from the reading of the decision of the Administrative Court *(Cour administrative, 30 janvier 2024, n°49145C)* that such tax assessment for the year 2013 was in fact in line with the return filed, recognizing the existence of the PE in 2013.
2) E. Lebas, "Tax controversy series – Administrative court judgment on US branches", AGEFI Luxembourg, September 2023 p. 13.
3) Free translation of the French original text by the authors.
4) European Commission, Competition: State Aid Cases: SA.38945 Alleged aid to Mc Donald's – Luxembourg, 3 December 2015.
5) Official Journal of the European Union, L 195, vol. 62 (23 July 2019).
6) For more detailed information see E. Lebas, "Recent Amendments to EU, Luxembourg and US Tax Laws, and their implications for US holding and financing branch structures", Bulletin for International Taxation, IBFD, vol. 73, nº 11, 2019.
7) Free transaction of the French original text by the authors.
8) Cour administrative, 21 avril 2021, n°45298C.