Euro Tax Flash from KPMG's EU Tax Centre

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

Fiscal State Aid – Tax Rulings – Ireland – Luxembourg – The Netherlands – Transfer Pricing – Selectivity

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 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 (see ETF 271), Luxembourg and the Netherlands (see ETF 262), and more recently Ireland (see ETF 300 and ETF 307) and again Luxembourg (see ETF 339 and ETF 372), 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 (see ETF 395). 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.

EU Tax Centre comment

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. However, both decisions provide much needed clarification on whether the Commission is entitled to refer to the arm's length principle when pursuing State aid investigations and on how the way the Commission performed the corresponding transfer pricing analysis may impact the procedures currently pending, including the Irish rulings case.

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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