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General Court decision in Gibraltar State aid case

General Court – Gibraltar – State aid – Interest and royalties – Tax rulings - Selectivity

On April 6, 2022, the General Court of the European Union (General Court or the Court) gave its decision in a case concerning the compatibility with EU law of Gibraltar's corporate income tax exemption regime for royalties and of related individual tax rulings (T-508/19).

The General Court partially annulled the State aid decision issued by the Commission, in so far as it relates to individual aid granted to the plaintiff, based on a tax ruling, for the period 2014 onwards. The annulment also covers the order for recovery connected with that measure. On the other hand, the Court upheld the Commission's finding based on which Gibraltar's corporate tax exemption for royalty income applicable until December 31, 2013 constitutes unlawful State aid.

Background

Following a complaint filed by Spain in June 2012, the European Commission launched in October 2013 a first in-depth investigation into whether the tax exemption for interest and royalty income (applicable between January 1, 2011 and June 30, 2013 and December 31, 2013, respectively) might grant a selective advantage to companies that generate these types of income. The inquiry was subsequently extended to 165 related tax rulings issued by the Gibraltar tax authorities between 2011 and 2013.

On December 19, 2018, the Commission decided that Gibraltar's exemption scheme constitutes State aid incompatible with the internal market (the Decision). In addition, the Commission concluded that five individual rulings granted by the Gibraltar tax authorities - out of the 165 reviewed, involved illegal State aid. These five rulings concerned the tax treatment of royalty and interest income generated by Dutch limited partnerships. Both Gibraltar and the Netherlands provided that profits realized by a limited partnership in the Netherlands should be taxed where its partners are resident for tax purposes, i.e. in Gibraltar. However, the income was not taxed in Gibraltar, based on the tax exemption available at that time and confirmed under tax rulings issued locally – see Euro Tax Flash Issue 390 for further details. In short, according to the Commission, the rulings endorsed the passive interest and royalty income exemption for the period prior to the 2013 amendment and allowed beneficiaries to continue to benefit from the exemption afterwards.

By July 14, 2021 Gibraltar completed the recovery of the State aid found to be unlawful from all beneficiaries - see E-news Issue 140. In parallel, the beneficiary of one of the tax rulings, that received royalty income from a Dutch partnership, decided to appeal the Decision before the General Court[1].

The General Court decision

The General Court noted that the appeal is divided in three main parts, i.e. i) the classification of the general exemption for royalty income applicable until December 31, 2013 as unlawful State aid, ii) the classification of the individual tax ruling granted to the plaintiff as unlawful State aid, and iii) the recovery order based on which the UK was required to retrieve the individual aid from the Dutch limited partnership or the parent of the Gibraltar company, if recovery from the latter was not possible.

General corporate income tax exemption for royalty income

Firstly, the General Court dismissed the plaintiff's plea that the Commission misused its power in relation to State aid to combat an apparent double exemption – i.e. the Gibraltar scheme that resulted in a double non-taxation of royalty income. In this regard, the Court noted that the fiscal autonomy of Member States does not automatically mean that all tax measures fall outside the scope of State aid rules. Instead, based on settled case-law, a measure granting certain entities an advantageous tax treatment and placing them in a more favorable financial situation than other taxpayers constitutes State aid. The Court also noted that the Commission examined Gibraltar's non-taxation of income – for which it has competence, and it did not take into account whether the royally income is taxed in the Netherlands.

The Court continued by endorsing the Commission's analysis related to the existence of a selective advantage. In this regard, the Court first confirmed that, by not taxing royalty income, Gibraltar introduced a tax reduction as compared to its 'normal' tax system and consequently created an economic advantage for companies benefiting from the exemption. Secondly, the Court recalled the three-step approach[2] used to assess the existence of a selective advantage and concluded that the non-taxation of royalty income was a selective measure. In short, the Court agreed with the selection

[1] Gibraltar is a British Overseas Territory to which, before the UK's exit from the European Union, the fundamental freedoms under the TFEU applied. The Withdrawal Agreement concluded between the EU and the UK covered Gibraltar, and as a result the CJEU remained competent for judicial procedures concerning Gibraltar registered at the CJEU before the end of the transition period (i.e. December 31, 2020).

[2] The three-step approach consists in: i) identifying the reference system of ordinary or 'normal' taxation; ii) determining if the relevant measure entails a derogation from the reference system; and iii) assessing if the derogation is justified by the nature or general scheme of the reference system.

of the reference framework – Gibraltar's tax code in force at that time, the objective of which was to collect corporate income tax from taxpayers receiving income accrued in or derived from Gibraltar. In that context, Gibraltar companies receiving royalty income should normally have been subject to tax in Gibraltar. Moreover, they were in a similar legal and factual situation to other companies receiving income accrued in or derived from Gibraltar. Consequently, in the Court's view, the measure under dispute represented a derogation from the reference framework and its objective.

In view of these considerations, the General court confirmed that Gibraltar's general exemption for royalty income represented unlawful State aid and upheld the related part of the Decision (i.e. Article 1).

Individual tax rulings granted to the plaintiff and recovery of the related State aid

The General Court started by rejecting the plaintiff's arguments that Article 2 of the Decision – covering the five individual tax rulings found to be unlawful State aid, refers to benefits received both for the period before the 2013 law amendment and for the period after that date. Instead, the Court considered that the plaintiff benefited from the aid measures based on the general exemption for royalty income for the period until December 31, 2013, and based on the individual tax ruling for the subsequent period.

With that in mind, the Court continued by analyzing the legality of Article 2 of the Decision. The General Court noted the complaints submitted by the plaintiff, according to which the Commission failed to comply with the requirements arising from the regulation governing State aid investigations. By citing its previous case-law, the Court confirmed that, at the stage of the opening decision, giving interested parties the opportunity to submit their observations is an essential procedural requirement in State aid investigations. In its view, the Commission is bound by the same requirement in cases where they changed their reasoning in a decisive manner between the opening decision and the final decision. In the case under dispute, the Court noted, the Commission's decision to extend the proceedings to individual tax rulings did not provide a clear indication that the review procedure also concerned the continued effect of the ruling after the 2013 legislative changes. In the Court's view, this element was decisive in identifying the measure investigated by the Commission and its absence deprived the beneficiary from the opportunity to provide comments.

In light of the above, the General Court decided to partially annual the Decision, in so far it relates to the individual aid granted to the plaintiff for the period 2014 onwards. The annulment also covers the order for recovery connected with that measure. The Court also concluded that, given the dismissal of the recovery order, it is no longer necessary to examine the arguments brought by the additional applicants – including the Dutch limited partnership and the parent of the Gibraltar company, regarding the legality of their inclusion in the recovery order.

EU Tax Centre comment

The General Court confirmed that Gibraltar's historic general exemption for royalty income represented unlawful State aid. The legislation was changed in Gibraltar from 1 January 2014. The General Court also ruled that State aid could be granted following the change of the legislation through tax rulings but that the Commission must follow essential procedural requirements in State aid investigations in order for their final Decision to be upheld, which they did not in this case. The General Court's decision does not impact directly the beneficiaries of the other four specific tax rulings deemed by the Commission as representing unlawful State aid. In terms of next steps, the Commission has the option to appeal the decision before the Court of Justice of the European Union.

The current ruling is the latest in a series of cases involving the Commission' inquiries into the compatibility of the tax ruling practices of Member States with EU law. Whilst the European Commission investigations concluded that State aid was present in a majority of key investigations, the General Court has generally ruled in favour of the taxpayer. A notable case still pending with the General Court is the UK's action against the European Commission's decision on the compatibility of the UK Group Financing Exemption scheme with EU State aid rules (T-363/19).

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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