Advocate General opinion on Luxembourg tax rulings related to intra-group financing structures

State aid – Luxembourg – Tax rulings – Double non-taxation

On May 4, 2023, Advocate General (AG) Juliane Kokott of the Court of Justice of the European Union (CJEU or the Court) rendered her opinion in the joined cases C-451/21 P and C-454/21 P, concerning two sets of tax rulings granted by the Luxembourg tax authorities in connection with intra-group financing structures.

The AG concluded that the European Commission and the General Court performed the selectivity analysis[1] based on an incorrect reference framework. The AG also concluded that only manifestly incorrect tax rulings under national law may constitute a selective advantage. As a result, the AG recommends that the Court finds that the EC erred in finding that Luxembourg had granted unlawful State aid to the plaintiff, and consequently, should set aside the judgment of the General Court and annul the related EC decision.

Background

On June 20, 2018, the European Commission issued a decision according to which two individual tax rulings granted by Luxembourg to a French group constituted illegal State aid (the Decision). In short, the rulings were issued with respect to structures that involved transactions between three companies – a holding company, a subsidiary and an intermediary. Under the rulings, only the subsidiary was taxed on a margin agreed with the Luxembourg tax administration. The EC determined that the result of the structures approved by the tax administration was that almost all of the profits of the subsidiaries established in Luxembourg were not taxed.

Among other considerations, the Commission was of the view that there was selectivity at the level of the parent companies because the tax rulings endorsed the application of the tax exemption for participation income to the

[1] It is settled CJEU case-law that the analysis of whether a national measure constitutes unlawful State aid requires several steps, including for the EC to demonstrate that the measure conferred a selective advantage on the beneficiary. For this purpose, the 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 rulings – is a derogation from that 'normal' system.

income received by the parent companies. In the Commission's view, that treatment derogates from a reference framework limited to the rules on tax exemptions for participation income. According to the Commission, a correspondence principle could be inferred from the applicable national law so that a tax exemption is only to be granted if the distributed profits have previously been taxed at the level of the subsidiaries.

An alternative line of argument was that the tax rulings derogate from the Luxembourg anti-abuse rule in that the tax authorities had unlawfully failed to apply the anti-abuse rule in tax legislation. In the Commission's view, the financing structure created by the group was abusive and the Luxembourg tax authorities consequently should not, on the basis of Luxembourg case-law, have issued those tax rulings (failure to combat abuse). see EuroTaxFlash Issue 372.

The taxpayers and the Luxembourg tax authorities initiated a judicial action before the General Court of the EU.

On May 12, 2021, the General Court upheld the EC's Decision. The General Court found that the Commission did not err in determining that the participation exemption at the level of a holding company is contingent on taxing the related income at the level of the subsidiaries, i.e. the General Court upheld the correspondence principle. The General Court also held that the EC demonstrated to the requisite legal standard a derogation from the provisions relating to abuse of law. For more details, please refer to E-news Issue 132.

Both the taxpayer involved in the proceedings and Luxembourg appealed the General Court's judgment before the CJEU – see E-news Issue 140 and E-news Issue 144.

The AG opinion

Review of tax rulings for compliance with State aid rules

The AG opinion emphasized that tax rulings do not, in themselves, constitute illegal State aid. Such rulings are a crucial tool to establish legal certainty, which is a general principle of EU law.

The AG acknowledged that, under a strict interpretation of the Treaty on the Functioning of the European Union (TFEU)[2], any tax ruling derogating from the reference framework could constitute State aid. However, the AG pleaded for a restricted standard of review in respect of tax law decisions taken by the tax authorities, which would be confined to a plausibility check. Under this approach, only *manifestly erroneous* tax rulings may constitute a selective advantage and therefore could infringe State aid rules. Whilst acknowledging that other tax rulings could nevertheless be incorrect, the AG considered that the review of rulings that do not entail a manifest derogation from the reference system would fall under the competence of local courts.

The existence of a principle of correspondence in the reference framework

The AG recalled that based on settled case-law the national law of the relevant Member States represents the sole reference framework for the purpose of the selectivity analysis. In the AG's view, irrespective of the reference framework selected (limited to the group relief provisions or the entire Luxembourg corporate income tax system), the key common element was represented by the alleged existence of a correspondence principle. The AG noted that both the EC and the General Court assumed that such principle was inferred by the Luxembourg tax law. The AG then agreed with the Luxembourg government that the link between the participation exemption and taxing the income at the level of the distributing entities was not manifestly apparent from the wording of the Luxembourg tax law. As a result, the AG concluded that the EC and the General Court based their selectivity analysis on an incorrect reference framework. Based on settled case-law, an error made in determining the reference system vitiates the entire selectivity analysis. The AG also rejected the EC's suggestion that, in the absence of such a correspondence clause, Luxembourg tax law was inconsistent and therefore constituted State aid in itself.

[2] Article 107(1) of the Treaty on the Functioning of the European Union

Derogation from the reference framework by not applying the abuse of law provision

The AG then turned to the EC's plea that Luxembourg's tax rulings disregarded the general anti-abuse rules (GAAR) provided by the national tax law, and therefore infringed State aid rules. In this context the AG noted that, contrary to the General Court's position, GAARs are generally difficult to be interpreted. Therefore, the AG suggested that the standard of review for assessing the applicability of GAARs in the context of State aid assessments should also be reduced to a plausibility check. In the AG's view, only cases that entail a manifest misapplication of the GAAR could infringe State aid rules. A manifest misapplication would exist only in cases where it would not be possible to explain plausibly why the case in question should not be considered a matter of abuse. In the AG's view, the EC needed to demonstrate that the Luxembourg tax authorities would have applied the local GAAR in other cases involving comparable factual and legal situations. The AG concluded that, in the current proceedings, the existence of abuse was not obvious – based on administrative practice in Luxembourg or interpretation applied domestically, and that the EC did not demonstrate the existence of abuse in accordance with local rules.

Considering the above, the AG concluded that tax rulings under dispute do not represent a selective advantage in favor of the taxpayer. The AG recommended therefore that the Court should set aside the judgment of the General Court and annul the related EC Decision.

ETC Comment

The current AG decision is the latest in a string of cases related to European Commission State aid investigations into individual tax rulings granted by Member States. Unlike other tax-related State aid case where the focus of the EC was on allegedly unjustified transfer pricing or allocation of profits, the present case dealt with internal mismatches and a supposed inconsistent application of national law, leading to double non-taxation.

Several points from the AG opinion are noteworthy. First, the suggestion that the EC and the courts of the EU should adopt a limited standard of review, reduced to a plausibility check, when assessing individual tax rulings for compliance with State aid rules. The AG emphasized the need to ensure that only *manifestly* incorrect tax rulings under the relevant national law are scrutinized by the EC or the courts of the EU. Otherwise, in the AG's view, the Commission would become a de *facto tax inspector* and the courts of the EU would play the role of the supreme tax courts. This outcome would infringe on the Member States' fiscal autonomy and would also significantly overburden both the EC and the courts of the EU. It would be very interesting to see if the CJEU will adopt the same line of reasoning and the limited standard of review.

Secondly, the current proceedings mark the first occasion for the Court to address whether the misapplication or non-application of a general anti-abuse rule in national tax law constitutes State aid under the TFEU. In this context, the AG also recommended a limited standard of review, reduced to a plausibility check. If the CJEU decides to adopt this approach, the EC would have a higher burden of proof. As such, the EC would need to establish a clear failure by tax authorities to apply domestic anti-abuse rules. It would not suffice to demonstrate how such rules would generally apply to other taxpayers, but rather the EC would be required to prove a clear non-application in comparison to taxpayers in similar factual and legal circumstances.

AG opinions are non-binding on the CJEU and it remains to be seen if the CJEU will follow the AG's recommendations. Once the CJEU decision is issued, it will be also interesting to see whether the Commission will put on hold or dismiss the in-depth investigations still pending at their level.

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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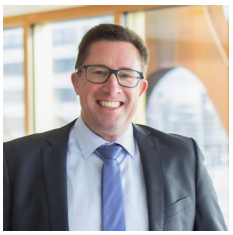

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