Advocate General opinion on Luxembourg tax rulings related to intra-group license agreement

State aid – Luxembourg – Transfer pricing ruling – Selectivity – Determining the reference system – Arm's length principle

On June 8, 2023, Advocate General (AG) Juliane Kokott of the Court of Justice of the European Union (CJEU or the Court) rendered her opinion in case C-457/21 P. The case concerns the validity of a decision issued by the European Commission (Commission or the EC), which found a transfer pricing ruling granted by the Luxembourg tax authorities in connection with an intra-group license agreement to be incompatible with EU State aid rules.

The AG concluded that the reference system[1] – the OECD Transfer Pricing Guidelines, which had not been implemented into Luxembourg law – relied on by the European Commission was incorrect. The AG also concluded that the Commission failed to demonstrate that the tax ruling conferred an economic advantage to the taxpayer. As a result, the AG recommended that the Court upholds the General Court's judgment, which annulled the Commission's decision.

Background

On October 4, 2017, the European Commission found that a tax ruling granted by the Luxembourg tax authorities in 2003, with respect to the method for calculation of the 'arm's length' royalty to be paid under an intra-group license agreement between two Luxembourg entities, constituted illegal State aid. Essentially, the Commission considered that the royalty calculated in accordance with the method endorsed in the tax ruling was too high and resulted in an artificial reduction of the tax base for corporate income tax purposes of the Luxemburg paying entity. The EC's decision highlighted a series of perceived errors as regards the choice and application of the method used to calculate the 'arm's length' level of the royalty payment (the transactional net margin method – TNMM).

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[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.

Both Luxembourg and the taxpayer appealed the EC's decision before the General Court of the European Union (General Court) – cases T-816/17 and T-318/18 A.

On May 12, 2021, the General Court issued its judgments in these two cases. Starting from the reference system proposed by the Commission – which included a version of the arm's length principle as prescribed by the OECD Transfer Pricing Guidelines (from 1995, 2010 and 2017), the General Court found the Commission's transfer pricing analysis and selected methodology to be incorrect. The General Court also considered that the Commission did not establish the existence of an advantage. Consequently, the General Court annulled the contested decision in its entirety – see E-news 132.

The Commission appealed the General Court's ruling before the CJEU. The main grounds of appeal included: i) the General Court misapplied the arm's length principle when it found that the Commission's functional analysis was flawed, and ii) the General Court erred in finding that no advantage was granted to the taxpayer.

The AG opinion

Correct determination of the reference system

First, the AG recalled that, based on settled case-law, an error made in determining the reference system vitiates the entire selectivity analysis. The AG continued by examining whether the reference system – used both by the Commission and the General Court in their respective analysis, was determined correctly.

The AG acknowledged that neither Luxembourg, nor the taxpayer challenged the determination of the reference system in their previous actions. Nevertheless, in the AG's view, the question whether the reference system was determined correctly was inseparably connected with the existence of a selective advantage. Therefore, in the AG's view, the reference system had to be reviewed in the context of the appeal.

The AG noted that, in light of existing case law, when examining whether there is a selective advantage and when establishing the tax burden that should normally be borne by a taxpayer, parameters and rules external to the national tax system at issue cannot be considered, unless that national tax system makes explicit reference to them – see EuroTaxFlash 492 for further details on related CJEU decisions. Based on settled case-law, outside the spheres in which EU tax law has been harmonized, it is for the Member State concerned to determine the characteristics of their own 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.

The AG noted that the Commission based its analysis of the appropriate royalty amount on the OECD Transfer Pricing Guidelines, notwithstanding the fact that Luxembourg law, at the time the tax ruling was issued, did not refer to those guidelines. The AG noted that the Commission based its analysis of the appropriate royalty amount on the OECD Transfer Pricing Guidelines, notwithstanding the fact that Luxembourg law, at the time the tax ruling was issued, did not refer to those guidelines. As a result, in the AG's view, the EC applied a different arm's length principle from that codified in Luxembourg law. The AG concluded that – given that the Commission did not use Luxembourg law and administrative practice as the relevant reference system for its review of a selective advantage, the findings in the decision at issue were vitiated by error of law. The General Court was thus entitled to annul the Commission's decision, although on reasons other than those on which it relied.

In an alternative line of reasoning, the AG analyzed the validity of the appeal should the CJEU decide to consider itself bound by the choice of the incorrect reference system. The AG reiterated the comments made in the AG opinion for joined cases 451/21 P and C-454/21 – see EuroTaxFlash 511. 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. The AG then applied the restricted standard to the case at hand and noted that both the transfer pricing method applied by the EC, as well as the one found by the General Court to be the correct one, are prescribed by the OECD Transfer Pricing Guidelines. Moreover, no method has a compelling priority over the other and a flexible approach could apply in complex cases. As a result, in the AG's view, the computation methodology endorsed by the tax ruling was not a manifestly erroneous interpretation of the OECD Transfer Pricing Guidelines. Considering the above, the AG concluded that the tax ruling under dispute does not represent a selective advantage in favor of the taxpayer.

Existence of an economic advantage

The AG continued by examining the second ground of appeal. The AG noted that the burden of proof regarding the existence of an economic advantage granted to the taxpayer stays with the EC. The AG then noted that the Commission's decision was focused on highlighting perceived errors in the transfer pricing computation endorsed by the rulings. However, under settled case-law a selective advantage only arises from tax rulings conferring more favorable treatment compared to normal taxation. As the contested decision did not include a comparison between the two, the AG concluded that the General Court was correct in determining that the Commission was unable to demonstrate that the tax ruling conferred a selective advantage.

Based on the above, the AG concluded that the tax ruling under dispute does not represent a selective advantage in favor of the taxpayer. The AG recommended therefore that the Court should uphold the judgment of the General Court, which annulled 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. Given the similarity of the issue under dispute with joined cases C-885/19 P and C-898/19 P, which also dealt with the role of the OECD's arm's length principle and guidelines in the context of State aid reviews, the AG's conclusions are not surprising.

The AG reiterated the Court's previous decisions that, when determining the reference system for the purposes of the selectivity analysis, the Commission must consider the legislative choices of a Member State and the version of the arm's length principle codified in domestic law, rather than an international standard.

In the alternative line of reasoning, the AG applied the revised standard of review, as outlined in the recently published opinion in the joined cases C-451/21 P and C-454/21 P). It would be very interesting to see if the CJEU will adopt the same line of reasoning, i.e. that only tax rulings which are manifestly erroneous in favor of the taxpayer could constitute a selective advantage.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, KPMG in Luxembourg, or, as appropriate, your local KPMG tax advisor.

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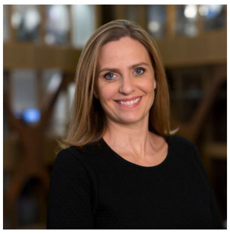

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