Euro Tax Flash from KPMG's EU Tax Centre

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The CJEU annuls Commission decision on Luxembourg tax rulings related to intra-group financing structures

CJEU – State aid – Luxembourg – Tax rulings – Double non-taxation – Advantage – Selectivity – Abuse of law

On December 5, 2023, the Court of Justice of the European Union (CJEU or the Court) gave its decision in the joined cases C-451/21 P and C-454/21 P. Both cases concern the validity of a decision issued by the European Commission (the "Decision"), which found two sets of tax rulings granted by the Luxembourg tax authorities in connection with intra-group financing structures to be incompatible with EU State aid rules.

The cases were first disputed in front of the General Court of the EU, which ruled in favor of the European Commission (Commission or the EC). In the appeal brought before it, the CJEU concluded that the General Court was wrong to confirm the Commission's approach in determining the reference system[1]. Finding that the selectivity analysis was vitiated, the CJEU decided to set aside the General Court's judgement and to annul the Commission's Decision.

Background

The European Commission's Decision

On June 20, 2018, the Commission issued a decision with respect to individual tax rulings granted by the Luxembourg tax authorities to a French group between 2008 and 2014, endorsing the tax treatment of a structure leading to limited profit of the Luxembourg subsidiaries being taxed in this jurisdiction. In short, the rulings were

[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.

issued with respect to structures that involved transactions between three companies – a holding company, a subsidiary and an intermediary. Under the rulings, only the subsidiaries were taxed, based 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 the profits of the subsidiaries established in Luxembourg were not taxed.

For the purpose of proving the selectivity of the rulings at hand, the Commission relied on three lines of reasoning. The first two were focused on the existence of a selective advantage at the level of the parent companies.

The first line of reasoning was based on the EC's view that the reference framework rested on the principle (derived from the EC's reading of a number of articles in the Luxembourg tax law) that Luxembourg companies that are resident and liable to corporation tax in Luxembourg are taxed on their profit, as recorded in their accounts. The Commission concluded that the rulings conferred a selective advantage on the parent companies, as they derogated from the Luxembourg corporate income tax system by allowing the income from the participations concerned not to be taxed.

The second line of reasoning was based on a narrower reference framework, limited to the rules on tax exemptions for participation income. In this context the Commission was also of the view that there was selectivity in the taxation of the parent companies because the tax rulings endorsed the application of the tax exemption for participation income to the 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, inter alia, 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. Both the taxpayer and Luxembourg appealed the EC's decision in front of the General Court of the EU.

The General Court's Decision

On May 12, 2021, the General Court upheld the EC's decision. The General Court confirmed the Commission's approach of applying the above-mentioned correspondence principle with regards to looking at the combined effect of not taxing the income at the level of a subsidiary and the subsequent exemption of that income at the level of its parent company. Departing from the literal interpretation of the Luxembourg's law provisions, the General court endorsed the EC's approach of examining such complex intra-group financing structures in accordance with the "economic and fiscal reality".

With regards to the alternative line of reasoning, the General Court also held that the Commission correctly ascertained that the taxpayer group was granted with a selective advantage by virtue of the Luxembourgish tax authorities not applying the domestic GAARs.

Both the taxpayer involved in the proceedings and Luxembourg appealed the General Court's judgment before the CJEU.

The AG's opinion

On May 4, 2023, Advocate General (AG) Kokott concluded that the European Commission and the General Court performed the selectivity analysis based on an incorrect reference framework. On a related note, the AG suggested 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.

The AG also concluded that only manifestly incorrect tax rulings under national law may constitute a selective advantage. 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.

As a result, the AG recommended 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. For more details, please refer to EuroTaxFlash Issue 511.

The CJEU decision

First grounds of appeal: the existence of a principle of correspondence in the reference framework

First, the CJEU recalled its settled case-law, highlighting its decision in the joined cases C-885/19 P and C-898/19 P, on the elements based on which a national measure would be classified as unlawful State aid. The Court continued by noting that, in cases involving tax measures, the determination of the reference framework is of particular importance since the existence of an economic advantage may be established only when compared with 'normal' taxation.

The CJEU further noted that, in the context of determining the reference system, the EC interpreted the Luxembourg law based on the assumption that 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. In this context, the Court recalled its settled case-law under which, in the absence of harmonization in EU law, each Member State has exclusive competence in the field of direct taxation to determine at their own discretion the characteristics of their domestic tax system. Additionally, the principle of legality of taxation, which is a general principle of EU law, requires that tax obligations and the related substantive features are clearly established by law. This includes ensuring that the taxpayer can anticipate and compute the tax liability, as well as determine the time at which this tax becomes payable.

Based on the above, the CJEU concluded that, when determining the reference system, the EC should in principle be required to accept the interpretation of provisions of national law given by the Member State during an exchange of arguments, provided that that interpretation is compatible with the wording of those provisions. In the CJEU's view, the EC may depart from that interpretation only if it is able to establish, on the basis of reliable and consistent evidence that has been the subject of that exchange of arguments, that another interpretation prevails in the case-law or the administrative practice of that Member State.

In respect to the EC's first line of reasoning, the Court noted that, when determining the reference system, the EC must also take into account exemptions that are considered relevant by the national tax authorities of the Member State concerned. This requirement applies as long as such provisions do not manifestly discriminate between companies and do not, in themselves, confer a selective advantage. The CJEU therefore concluded that the EC is not allowed to establish a derogation from a reference framework solely by finding that a measure deviates from a general objective of taxing all resident companies, without taking into account the provisions of national law specifying the manner in which that objective is to be implemented.

The Court then noted, in the context of the EC's second line of reasoning, that the interpretation given by Luxembourg to the rules at hand is that they do not include an explicit requirement that the exemption of income from participations for a parent company is conditioned on the taxation of distributed profit at its subsidiary's

level. Moreover, in the Court's view, none of the evidence presented by the EC invalidated Luxembourg's interpretation. Additionally, the Court determined that Luxembourg's interpretation aligns with the wording of the rules at hand.

As a result, the CJEU 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. Consequently, the Court upheld the plaintiffs first grounds of appeal.

Second grounds of appeal: derogation from the reference framework by not applying the abuse of law provision

The CJEU then turned to the plaintiffs' plea that the General Court erred in finding that the Commission could disregard the national administrative practice in Luxembourg in the context of the EC's conclusion that the Luxembourg's tax rulings disregarded the general anti-abuse rules (GAAR) provided by the national tax law. The CJEU upheld the AG's views that GAARs, due to their general nature, could apply across an extensive range of contexts and situations.

Therefore, in the Court's view, when analyzing the existence of a selective advantage, the EC should have considered whether the tax ruling under dispute deviated from the national case-law or administrative practice of the Luxembourg tax authorities relating to applying the domestic GAAR. If this were not the case, in the CJEU's view, the Commission would overstep its authority by defining the correct application of local anti-abuse rules, infringing upon Member States' fiscal autonomy.

In light of the above, the CJEU concluded that the General Court erred in law when it held that the EC was not required to take into account the administrative practice of the Luxembourg tax authorities when applying the domestic GAAR, on the ground that such provision did not give rise to any difficulties of interpretation. Consequently, the CJEU also upheld the plaintiffs' second grounds of appeal.

CJEU's findings on the actions for annulment

Whilst looking at the please for annulment brough forward by the plaintiffs, the Court recalled the various errors performed by the EC in its assessment of the reference framework defining the normal tax system, *including inter alia* the findings above. Moreover, the Court stated that by not accepting this interpretation and defining the reference framework solely based on the general objective, the Commission disregarded the fiscal autonomy and competence of the Member State. The Court acknowledged that the determination of the basis of assessment, the taxable event, and any exemptions to which the tax is subject are the exclusive competences of the Member State in the matter of direct taxation.

In light of the above, the CJEU held that the various errors vitiated the whole of the selectivity analysis. As a result, the CJEU decided to set aside the General Court's ruling and to annul the EC's Decision.

ETC Comment

The current CJEU ruling is the latest in a string of cases related to European Commission State aid investigations into tax rulings granted by Member States to certain multinational enterprises operating in the EU. 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. The ruling at hand also marks 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 Treaty on the Functioning of the European Union (TFEU). The Court upheld the AG's opinion on this point, noting that a provision intended to prevent abuse in tax matters horizontally is inherently general in nature, and may therefore be applied in a very wide range of contexts and situations. It is up to the Member States to include such a provision in their national law and to define the limits of its implementation by tax authorities. The Court

noted that the Commission could only conclude that the non-application of that general anti-abuse provision in Luxembourg law by the tax authorities (in the tax ruling request) resulted in a selective advantage if that non-application was a departure from the national case-law or administrative practice relating to that provision. In line with the AG's opinion, the Court noted that - absent such a reliance on domestic case-law and practice, the Commission would essentially be able to define what does or does not constitute a correct application of a provision if national law, which would exceed the limits of the powers conferred on it by the Treaties in the field of State aid review and would be incompatible with the fiscal autonomy of the Member States. With regard to the Commission's examination in the case at hand, the Court noted that the EC confined itself to a general review of the conditions for the application of the relevant article of Luxembourgish Law and did not establish that, in the tax rulings at issue, the Luxembourg tax authorities had departed from their own practice concerning comparable transactions

The ruling at hand does not touch upon the AG's plea for a limited standard of review based on which the EC and the courts of the EU would only scrutinize manifestly incorrect tax rulings under the relevant national law.

It will be interesting to see the extent to which the Court's decision in the case at hand will be reflected in the outcome of case C-555/22 P, currently under appeal in front of the CJEU. The case concerns the compatibility of the UK Controlled Foreign Companies (CFC) Group Finance Company Partial Exemption Rules ("Finco Exemption") with EU State aid rules. In previous proceedings, the General Court rejected the plaintiffs' claims that the EC erred in law by selecting a narrow reference system, i.e. the UK's CFC rules, instead of the general CIT system in the UK. Instead, the General Court endorsed the EC's narrow reference system and argued that, in their view, the reference framework could have a narrower scope than the general system. In the General Court's view, the CFC rules were based on a distinct logic and could be severed from the general corporate system for State aid analysis purposes. For more details, please refer to EuroTaxFlash Issue 477.

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

Raluca Enache
Associate Partner,
Head of KPMG's EU Tax Centre

Ana Pușcaș
Senior Manager,
KPMG's EU Tax Centre

Olivier Schneider
Partner
KPMG in Luxembourg

Maximilian Frolik
Intern,
KPMG's EU Tax Centre

Felix Kohlstetter
Intern,
KPMG's EU Tax Centre

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KPMG's EU Tax Centre, Laan van Langerhuize 9, 1186 DS Amstelveen, Netherlands

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