



# 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 license agreement**

#### **[CJEU – State aid – Luxembourg transfer pricing ruling – Selectivity – Determining the reference system – Arm's length principle](#)**

On December 14, 2023, the Court of Justice of the European Union (CJEU or the Court) gave its [decision](#) in case C-457/21 P. The case concerns the validity of a decision issued by the European Commission (the “Decision”), 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.

In the appeal brought before it, the CJEU concluded that the General Court wrongly recognized the arm's length principle as having general application within the context of the implementation of EU State aid rules. By relying on such principle, the EC incorrectly defined the reference system, the Court said. Finding that the selectivity analysis<sup>1</sup> was vitiated, the CJEU upheld the General Court's ruling of annulling the EC's Decision.

## **Background**

### *The European Commission's Decision*

On October 4, 2017, the Commission issued a [Decision](#) regarding a tax ruling granted by the Luxembourg tax authorities in 2003, endorsing the calculation of arm's length royalty payments for an intra-group license agreement between two Luxembourg entities. In its Decision, the EC considered this tax ruling as unlawful State aid. In the EC's view, the ruling endorsed a profit calculation considered to be too high, thus reducing the tax base

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<sup>1</sup> 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.

for corporate income tax purposes. As such, the EC considered that the ruling granted a selective advantage to the taxpayer.

The Commission held that a series of errors were made by Luxembourg with respect to the transfer pricing arrangement endorsed in the tax ruling as regards the choice and the method used to calculate the royalty payment. In its analysis, for the purpose of establishing the existence of a selective advantage, the EC used a reference system which included a version of the arm's length principle as prescribed by the OECD Transfer Pricing Guidelines (from 1995, 2010 and 2017) (the OECD Guidelines).

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

### *The General Court's Decision*

On May 12, 2021, the General Court issued its [judgment](#) in the two referenced cases. The General Court did not dispute the reference system used by the EC. However, the General Court found the Commission's transfer pricing analysis and the selected methodology to be incorrect and therefore ruled that the EC had failed to establish the existence of a selective advantage. Consequently, the General Court annulled the Commission's decision in its entirety.

The Commission appealed the General Court's ruling before the CJEU.

### *The AG's opinion*

On June 8, 2023, Advocate General (AG) Juliane Kokott of the CJEU rendered her [opinion](#) in the case referred to the CJEU. AG Kokott concluded that the Commission had relied on an incorrect reference system, since the arm's length principle and the OECD Transfer Pricing Guidelines were not incorporated nor referenced in the Luxembourg tax law at the time the ruling was issued. Consequently, in the AG's view, the General Court was entitled to annul the EC's decision as, based on settled case-law, an error in determining the reference system vitiates the entire selectivity analysis – see Euro Tax Flash [Issue 515](#).

### **The CJEU's decision**

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 Court repeated that an error made in determining the reference system vitiates the entire selectivity analysis.

The CJEU further noted that only national law applicable in the Member State concerned must be taken into account when identifying the reference system in direct taxation matters. Quoting its previous case-law, the CJEU held that the arm's length principle can only be part of the reference framework if it is incorporated into national tax law. In the Court's view, such incorporation would require, at a minimum, an explicit reference to this principle in domestic law. The CJEU further noted that, in the context of State aid investigations, EU law does not include an autonomous arm's length principle that would apply irrespectively of whether the principle was incorporated in local law or not.

The Court then noted that the OECD Guidelines are not binding on the jurisdictions that are OECD members. In this context, the CJEU recalled that for the purposes of investigating the existence of a selective advantage, rules external to the national tax system can only be considered if that national tax system explicitly refers to them. As

such the EC was only entitled to rely on the OECD Guidelines if Luxembourg's national system made explicit reference to them.

In light of the above, the CJEU held that, due to the aforementioned errors in determining the reference framework, the EC vitiated the selectivity analysis and, consequently, failed to establish the existence of an advantage for the taxpayer. The CJEU then noted that the General Court erred in law by considering that the arm's length principle was enshrined in Luxembourg tax law and that the EC could rely on the OECD Guidelines.

Nevertheless, in the CJEU's view, the EC's Decision had to be annulled in any event due to the Commission's incorrect identification of the reference system. As a result, the CJEU upheld the judgment of the General Court which annulled the Commission's Decision, albeit on different grounds than those of the General Court.

### ETC Comment

The current ruling is the latest in a string of cases related to the European Commission's State aid investigations into individual tax rulings granted by Member States. The Court referenced heavily its decision in joined cases C-885/19 P and C-898/19 P - see [Euro Tax Flash 492](#), which similarly dealt with the role of the OECD's arm's length principle and the OECD Transfer Pricing Guidelines in the context of State aid reviews. In light of the Court's conclusions in previous case law, it is not surprising that the CJEU reiterated that rules that are external to the national tax system (such as non-binding OECD principles that have not been incorporated into EU law) should only be considered in defining the reference system (for the purposes of assessing the existence of a selective advantage) when explicitly referenced within the national tax system.

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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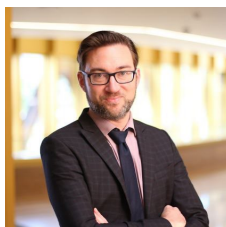
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