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Global Tax Alert

EU General Court rejects appeal in Luxembourg State aid case concerning financing company

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Executive summary

The European Commission (Commission) rendered its final decision in the State aid investigation into an Advance Pricing Agreement (APA) concluded by a Luxembourg company on 9 June 2016. The company forms part of a multinational company (MNC) group. The APA, which pre-dates the formal adoption of the Luxembourg transfer pricing framework with effect as from 1 January 2015, confirms the Luxembourg tax treatment of the financial services provided by the company to members of the MNC. On 24 September 2019, the European Union (EU) General Court (GC) delivered its judgment on the appeal of the Luxembourg Government and the company against the Commission's final decision. The GC rejected the arguments of Luxembourg and the MNC in this very fact-specific case. The Commission thereby confirmed that Luxembourg granted a selective tax advantage to the company by agreeing, in the context of an APA, to transfer prices that according to the Commission deviate from market practices. The decision is still subject to appeal in front of the Court of Justice of the EU (CJEU), the court of final instance in EU State aid proceedings.

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Detailed discussion

Background

The decision concerns an APA issued by the Luxembourg tax authorities to a Luxembourg member of an MNC group. This company provided financial services, such as intra-group loans, as well as treasury services, including management of cash pools, to other group companies. In addition, the company held two participations in group companies. The activities of the company were financed with equity, third-party debt and intra-group debt.

The Luxembourg entity's fact pattern was very specific, in that it raised funds on the market, distinguishing the company from most of the Luxembourg group finance companies that provide intra-group loans out of funds provided by other group companies. In addition, the company's method of calculating profitability by applying specific equity returns to each pre-determined category of equity (regulatory capital, equity used to finance shareholdings, equity to perform functions) is not a commonly used approach to measure the remuneration of a company performing intra-group financing and treasury activities. Finally, the case concerns a situation prior to the adoption of more detailed transfer pricing legislation in Luxembourg with effect from 2015 and 2017.

The Decision

The GC confirmed the Commission's statements that integrated and standalone companies are in a comparable position in light of the Luxemburg tax law and stressed that compliance with the arm's-length principle is subject to State aid review. It moreover confirmed that the arm's-length principle is an appropriate tool which the Commission may use in the exercise of its powers to check whether the taxable profit of a company that forms part of a group corresponds to a reliable approximation of the taxable profit that would be generated under market conditions, by reviewing whether the transfer prices charged reflect those which would be charged under conditions of free competition. However, the GC also stated that Member States have a margin of appreciation in determining transfer pricing. It is only if the Commission finds an error in the determination of that pricing, which is such that the transfer pricing does not represent a reliable approximation of a market-based outcome, that the Commission is entitled to identify an aid measure.

Despite repeating the Commission's statement that the Commission cannot be formally bound by the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines, the GC did confirm that these guidelines have a real practical significance in the interpretation of issues relating to transfer pricing, as they reflect international consensus regarding transfer pricing. This is also corroborated by virtue of the (indirect) acceptance by the GC of the methods endorsed by the OECD for evaluating transfer prices, provided the chosen methods are justified and applied in a consistent and appropriate manner so as to approximate market conditions. According to the GC, an advantage within the meaning of the State aid rules may only be found to exist if the variation between the transfer pricing accepted by a Member State and the "reliable approximation of a market-based outcome" goes beyond the inaccuracies inherent in the transfer pricing methodology used to obtain such approximation.

In the case in front of the GC there was disagreement as to several elements in applying the chosen transfer pricing methodology. The calculation of the remuneration for the intra-group financing and treasury activities was performed by applying specific returns to different pre-determined categories of capital (regulatory capital, equity used to finance shareholdings, equity to perform functions), ultimately limiting the remuneration to a return on hypothetical regulatory capital rather than the company's whole capital. The GC rejected the arguments brought forward by Luxembourg according to which the transfer pricing method requires an allocation of the capital to the various functions performed by the taxpayer and confirmed that the whole amount of capital should have been taken into account for the computation of the remuneration on the intra-group financing and treasury activities performed by the Luxembourg company.

Finally, the GC refuted the MNC's argument, according to which there was no advantage at the group level as the lowering of tax in Luxembourg entailed a higher tax burden in another Member State. According to the GC, any advantage that would benefit this particular group company necessarily benefited the other group companies in respect of which it charged transfer prices. Despite this, the GC underlined that the tax situation of another group entity in another Member State is irrelevant for the determination of the existence of an advantage in the Member State concerned.

Implications

Given that the judgment is subject to appeal in front of the CJEU, it is advisable to monitor further developments in this case. If the GC decision is appealed against, among other arguments brought forward by Luxembourg in the case in front of the GC, the CJEU will have to consider whether the Commission is entitled to prescribe methodological standards for determining taxable profit that do not appear in national legislation in place at the time of the APA and therefore apply a form of arm's-length pricing that is allegedly extraneous to Luxembourg tax law.

The facts of the case are very specific and there may be considerable variations compared to the facts of other taxpayers. Nevertheless, as the GC based a number of its conclusions on the alleged inappropriate application of a specific transfer pricing method, it is recommended that transfer pricing analyses be reviewed for consistency purposes.

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