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EU Tax Alert

EU Law and Tax Departments – EU tax practice
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The General Court delivers judgements on the legitimacy of the tax rulings granted by Luxembourg to Engie and Amazon

Since 2014, as part of wider strategy, the EU Commission started a deep analysis on tax advantages granted by EU Member States to selected multinational Groups, in the form of tax rulings and/or tax sweeteners. Given that EU Member States interventions in this area, *i.e.*, direct taxation, currently fall outside the EU competence, in order to tackle this phenomenon and to restore fair competition in the Internal Market, the EU Commission is mostly relying on State aid rules (Articles 107 and 108 TFEU).

This approach led to the setting up of a dedicated Task Force on Tax Planning Practices within the Directorate General of Competition, led by Executive Vice-President Margarete Vestager.

So far, the EU Commission opened a number of in-depth investigations under Article 108 TFEU, mostly directed to tax advantages - schemes and *ad hoc* measures - adopted by certain EU Member States (namely, Luxembourg, Belgium and The Netherlands), that have been closed with the adoption of negative decisions claiming the recovery of illegal State aids. Only in one case the EU Commission excluded the existence of State aids under Article 107, para 1, TFEU.

Some of these decisions have been annulled by the General Court ("**EUGC**")[1]. However, in its judgments, the EUGC confirmed the EU Commission's jurisdiction to investigate tax rulings under State aids rules, notwithstanding the principle of fiscal autonomy of EU Member States.

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[1] See *inter alia* T-778/16 and T-892/16 *Apple Sales International and Apple Operations Europe/ Commission*; T-760/15 and T-636/16 *Netherlands and others / Commission* ("*Starbucks*"); T-131/16 and T-263/16 *Belgium and Magnetrol International / Commission* (*"Excess Profits Scheme"*). Note that in the Opinion of the Advocate General in the appeal introduced by the EU Commission before the Court of Justice of the EU in the latter case, have been delivered last December. The Advocate General is suggesting the Court of Justice of the EU to annul the EU General Court's judgment.

In the "Engie"[2] and "Amazon"[3] cases, the EUGC assessed whether the tax rulings granted by Luxembourg to companies belonging to the Engie and Amazon corporate Groups constitute illegal State aid according to Article 107 TFEU.

The EUGC concluded that Luxembourg granted an illegitimate aid to the Engie Group, while this was not the case with reference to the Amazon Group. The decisions delivered by the EUGC may be appealed before the Court of Justice of the EU ("**CJEU**") on point of law.

In this newsletter, we analyze the most significant points of interest of the EUGC judgements in the above cases.

1. The Engie cases

The Engie Cases regarded a set of tax rulings granted between 2008 and 2014 by Luxembourg to the Engie Group in relation to certain financing arrangements.

These arrangements were constituted by a "*Zero-intérêts Obligation Remboursable en Actions*" ("**ZORA**"), leading to a hybrid mismatch (*i.e.*, a deduction without inclusion outcome)[4].

In particular, the ZORA generates deductible interest in the hands of the borrower, which however are not financially paid over the years; further, the borrower repays the ZORA by converting the loan into equity and by issuing – in favor of the lender – shares whose amount is equivalent to the nominal amount of the loan, plus a premium representing the profits made by the borrower during the term of the ZORA ("**ZORA accretions**"). The lender benefits from the participation exemption in relation to such shares.

The EU Commission maintained that the relevant tax rulings constituted illegal State aid, in essence on the following grounds:

(i) under the normal tax rules, Luxembourg does not permit to deduct expenses to the extent they give rise to a corresponding exempt income at the level of the recipient;

(ii) Luxembourg should have applied its general anti-abuse rule to prevent an unlawful selective advantage under the EU State aid regime.

The EUGC confirmed the EU Commission's approach, holding in summary that:

(i) the EU Commission duly demonstrated that the tax rulings triggered a reduction in the amount of tax which would normally have been payable under the ordinary tax regime;

(ii) the arrangements under analysis should be assessed on a substance-over-form approach;

(iii) the participation exemption at the level of a parent company is dependent on the tax regime at the level of its subsidiary of profits distributed by that subsidiary;

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[2] T-516/18 Luxembourg v Commission and T-525/18 Engie, Engie Global LNG Holding Sàrl and Engie Invest International SA v Commission.

[3] T-816/17 Luxembourg v Commission and T-318/18 Amazon EU Sàrl and Amazon.com,Inc. v. Commission.

[4] See examples No. 1.13 and 1.21 of the OECD (2015), Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241138-en

(iv) the arrangement was abusive under the Luxembourg general anti-abuse rule and, hence, granting a selective advantage, the Luxembourg tax authorities should have not endorsed the tax treatment in the rulings.

2. The Amazon cases

The Amazon cases regarded a set of tax rulings granted between 2006 and 2014 by Luxembourg to the Amazon Group in relation to the arm's length of certain royalty payments.

The rulings applied to royalties paid by a Luxembourg corporate entity ("**LuxOpCo**") to its 100% parent, a Luxembourg limited partnership ("**LuxSCS**"), for the use of certain intangibles, *i.e.*, technology, marketing intangibles and customer data.

LuxSCS held these intangibles through a licensing from US companies of the Amazon Group and was entitled to licensing them to LuxOpCo.

It is worth adding that LuxSCS can be considered as a "reverse hybrid" entity, it being treated as (i) tax transparent from a Luxembourg tax perspective, and (ii) tax opaque for US tax purposes (through the "check-the-box" regime)[5].

The EU Commission maintained that the relevant tax rulings constituted illegal State aid, in essence on the following grounds:

(i) LuxSCS did not perform any significant activity on the IP it licensed to LuxOpCo;

(ii) the arm's length pricing of the deductible royalty payments should have been determined based on the profit split method, rather than using the TNMM method with LuxOpCo as tested party.

The EUGC annulled the EU Commission's decision, as the latter failed in proving that there was an undue reduction of the tax burden.

In summary, the EUCG held that:

(i) the functional analysis of the EU Commission was incorrect, because it was based on OECD Transfer Pricing Guidelines developed after the tax rulings, while the applicable OECD Transfer Pricing Guidelines (*i.e.*, from 1995) did not require active functions towards the IP; in this context, licensing of intangibles constitutes exploitation;

(ii) the pricing by the EU Commission of the royalty at stake was incorrect, because the LuxSCS's functions linked to maintaining its ownership of the relevant intangible assets could not be treated as the supply of "low value adding" services;

(iii) the EU Commission did not sufficiently demonstrate that the choice of the profit level indicator or the application of the cap-and-floor mechanism reduced LuxOpCo's tax base.

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[5] See Chapter 4 of the OECD (2015), Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241138-en.

3. Final remarks

In the Engie and Amazon cases, the EUGC decided for the applicability of Article 107 TFEU – respectively – in the area of anti-avoidance measures and transfer pricing, once the outcome of tax rulings departs from "normal" taxation.

While this may not be a novelty with regard to transfer pricing, the need for EU Member States to tackle tax avoidance entails a new ground for possible challenges by the EU Commission. In this context, the EU Commission may interpret domestic anti-avoidance rules differently than the tax authorities of the EU Member States themselves.

If this approach of the EUGC were confirmed by the CJEU, it may have a significant impact also in light of the fact that the recovery period of illegal State aid can go 10 years backwards from when the EU Commission starts investigating a case.

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