EU Commission finds Luxembourg and the Netherlands granted illegal State aid and orders recovery

Executive summary

On 21 October 2015, the European Commission (the Commission) rendered its final decision in two State aid investigation cases relating to Luxembourg and the Netherlands. The Commission has determined that Luxembourg and the Netherlands granted illegal State aid to a Luxembourg-resident and a Dutch-resident company, respectively, which both form part of a multi-national company (MNC) group. The Commission found under the EU State aid rules that Luxembourg and the Netherlands have granted a selective tax advantage. The Commission ordered both Member States to recover the alleged advantage from the taxpayers.

Detailed discussion

The Commission found that the two tax rulings under investigation applied methods which in the Commission's view did not reflect economic reality. On that basis, the Commission has determined that prices set for goods and services sold between companies of each MNC group did not correspond to market conditions. The Commission held in one case that profits were shifted abroad, where they also were not taxed, whereas in the other case, the company paid taxes on underestimated profits. The Commission ordered Luxembourg and the Netherlands each to recover the unpaid tax. The amounts to recover are €20-30 million for each company.

Decision on Luxembourg tax ruling

The decision concerns an Advance Pricing Agreement (APA) issued by the Luxembourg tax authorities on the activities of a Luxembourg member of an MNC group. This company provided financial services, such as intra-group loans, as well as treasury services to other group companies.
The Commission found the APA granted by Luxembourg unduly reduced the company’s tax burden by €20–30 million since 2012. The Commission considers the activities of the MNC group company to be comparable to those of a bank. The Commission believes that the tax ruling endorses a complex methodology that is not appropriate for the calculation of taxable profits reflecting market conditions. According to the Commission, the APA lowered taxes in two ways:

- Due to a number of assumptions and downward adjustments, the capital base approximated by the tax ruling was found to be lower than the company’s actual capital.
- The estimated remuneration applied to this already lower capital for tax purposes was also lower than market rates.

The Luxembourg Ministry of Finance commented that “Luxembourg disagrees with the conclusions reached by the European Commission and reserves all its rights.” It continued by saying that Luxembourg had already noted that the Commission has used unprecedented criteria in establishing whether or not the company received selective advantages and that, in particular, the Commission has not established in any way that the company received selective advantages with reference to Luxembourg’s national legal framework. Luxembourg considers that there is no State aid and that it complies fully with the relevant international standards and with State aid rules.

Decision on Dutch tax ruling
The decision involves an APA issued by the Dutch tax authorities on the activities of a Dutch member of an MNC group. The company processed input products sourced from another member of the group based in another country which were then further distributed. In exchange for valuable intangibles, royalties were paid to another group company which also was based in another country.

The Commission determined that the APA lowered taxes paid by the MNC since 2008. The Commission's decision argues that the tax burden was lowered in two ways:

- First, the company was deemed to be paying a substantial royalty to a related UK-based company for intangibles.
- Second, the price paid for products bought from a related Switzerland-based company was too high.

The Commission notes that the royalty payments would not adequately reflect market value and should essentially have been ”zero.” On that basis, the Commission ordered the Dutch tax authorities to recover the alleged advantage of approximately €20–30 million.

The Dutch Government, in an initial statement, said that the decision by the Commission comes as a surprise as it believes that international standards were adhered to when concluding the tax ruling. The company, backed by the Dutch Government, has also expressed its concern. In this regard, the company stated that it plans to appeal the decision, as it followed the Dutch and Organisation for Economic Co-operation and Development (OECD) rules applicable to all taxpayers. Thus, it should not suffer the negative implications for applying well established national and international standards.

Implications
Implications on technical aspects of tax rulings and State aid
One of the take aways of these decisions is that the Commission generally recognizes tax rulings as “perfectly legal.” In the course of the press conference the Commissioner expressed that tax rulings are not in themselves problematic and that they are a useful tool to grant certainty to businesses. Hence, tax rulings seem not to be problematic under State aid rules as long as they reflect a proper application of tax laws.

These decisions conclude two out of four investigations that the Commission launched last year involving Ireland, Luxembourg and the Netherlands. All of these cases have in common that they revolved around aspects of transfer pricing and advance tax rulings. The Commission’s recovery orders are standard practice in State aid cases. Both Member States are generally given two months to calculate the actual amount of the alleged advantage and to recover it from the respective taxpayer involved. As a general rule, a possible appeal by the Member States and/or the taxpayers involved will not suspend the obligation to recover.
The Commission has not only ordered recovery but also specified a range of the amount to be recovered. The Commissioner for Competition, Margarethe Vestager, said the purpose of this approach is to provide guidelines on how to calculate the recovery, though the actual calculation has to be done by the respective Member State. For the Commission, it would be a matter of principle since the Commission advises on the correct methodology. According to the Commissioner both cases have different facts and circumstances, though they could be considered as examples on the correct approach to transfer pricing. Whether the Commission will issue material guidelines she left for the future.

The Dutch Government as well as the company concerned expressed their doubts in their initial statement, since they believe the Commission's decision contains significant errors. Indeed, the statements given by the Commissioner sharply deviate from established case law on fiscal State aid. This clearly provides that it is up to the Member States to design their corporate tax system as they deem appropriate, as long as the rules are applied consistently and equally to all taxpayers in the same situation. The imposition of new transfer pricing methodologies, which the Commissioner seems to be hinting at, appears at odds with this existing case law and could affect the competences of Member States in the area of corporate taxation. Also the Luxembourg Ministry of Finance referred to this debatable Commission approach by expressing that the Commission used unprecedented criteria to establish the alleged State aid. These topics are likely to become key in the upcoming appeals before the EU Courts in Luxembourg, either in today's cases or in future ones. Doubts remain over whether the Commission's approach will be sustained in any appeal proceedings.

Implications on pending investigations
There are still several State aid investigations which the Commission has yet to finalize. In particular, the Commission's final decisions in the other two pending investigations into individual tax rulings are eagerly awaited. As the Commissioner pointed out, there is neither an exact date set yet nor do today's decisions prejudge the outcome in the remaining two cases. The same applies to the Commission's investigation of the Belgian Excess Profit Ruling system formally initiated in February 2015. Several other investigations in relation to fiscal State aid are ongoing and are still at the informal procedural stage (i.e., the Commission has not yet decided whether to open formal investigations). The Commissioner claims that her goal is to get a horizontal overview on how tax rulings are used in the EU Member States. She has also stated that more cases may come, if circumstances indicate that EU State aid rules are not being complied with.

Implications on policy
The Commissioner did not hide the fact that the purpose of various State aid cases is not only to ensure undistorted competition (this is what the State aid rules are intended for) but are part of a wider policy agenda on corporate taxation, since she called for “a more fundamental shift in corporate philosophies.” The Commissioner stated that legislation would be necessary in order to close loopholes, mismatches and opportunities for profit shifting. The Commissioner explicitly referred to the Commission’s Action Plan for fair and effective taxation which includes a revamped CCCTB proposal to come, and the tax transparency package which includes an automatic exchange of tax rulings on which the ECOFIN has already politically agreed.

Finally, the Commissioner stated that “EU State aid enforcement is just one part of a wider package that needs to come together to effectively address corporate tax avoidance and tax evasion. But it also means that there is a big team that can get to work - here in the Commission, and together with the European Parliament, EU Member States, the OECD and other international partners as well as businesses.”

The key question is whether the Commission's State aid investigations will actually further corporate tax reforms. The opening decisions in the various cases give the impression that the Commission is picking up on many issues that
are already being addressed in the context of base erosion and profit shifting (BEPS). However, the way in which the Commission seems to approach these issues substantially deviates from the BEPS Action Plan. This could create confusion and legal uncertainty. Another concern is that State aid decisions have retroactive effect (and involve recovery of alleged benefits in the past). This is difficult for the business community to manage. The latter is typically willing to support change as long as reasonable transition periods are observed to enable businesses to adjust their structures in a smooth and non-disruptive way. Many commentators are also concerned about the impact of the current State aid investigations on the investment climate in the EU and the potential for loss of confidence in the EU as an attractive place to do business.

Endnotes

1. EU Commission, IP/15/5880.
8. See EY Global Tax Alert, EU Council reaches political agreement on the automatic exchange of information on tax rulings, dated 6 October 2015.
9. EU Commission, STATEMENT/15/5881.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft, Munich**
- Dr. Klaus von Brocke     +49 89 14331 12287     klaus.von.brocke@de.ey.com

**Holland Van Gijzen Advocaten en Notarissen LLP, Utrecht**
- Steven Verschuur       +31 88 40 73207     steven.verschuur@hvglaw.nl

**Ernst & Young Belastingadviseurs LLP, Amsterdam**
- Danny Oosterhoff       +31 88 40 71007     danny.oosterhoff@nl.ey.com

**Ernst & Young LLP (UK), London**
- Mat Mealey             +44 20 7951 0739     mmealey@uk.ey.com

**Ernst & Young LLP, Luxembourg Tax Desk, New York**
- Jurjan Wouda Kuipers   +1 212 773 6464     jurjan.woudakuipers@ey.com
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