# EU Court of Justice Faults European Commission for Expansive Interpretation of State Aid in Tax Rulings

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On November 8, 2022, the Court of Justice of the European Union (CJEU), overturning the first instance EU General Court (General Court), annulled the European Commission's (EC's) decision that a Luxembourg tax ruling on Fiat's intragroup financing transactions "did not reflect economic reality" and therefore amounted to unlawful state aid.[1]

The CJEU, ruling in Grand Chamber composition, rejected the EC's reliance on an "abstract" interpretation of the arm's length principle based on Organisation for Economic Co-operation and Development (OECD) principles. The CJEU concluded that this could not be relied upon in determining whether a measure conferred a "selective" advantage on Fiat (that is to say an advantage that was not generally available to all companies): Because EU member states have autonomy in direct taxation measures, it was not appropriate to hold them to an abstract OECD benchmark. The assessment of selectivity could only look at national law.

The CJEU's judgment limits the EC's efforts to apply an arm's length principle to national taxation systems as a matter of state aid law. Before the General Court, the EC had lost similar cases on the facts. The General Court held the EC was entitled to use its own interpretation of the arm's length principle. The CJEU now authoritatively determines that application of a non-national law benchmark is a legal error. The judgment adds much-needed legal certainty for companies and is likely to be a game changer for some of the parallel pending cases before the EC and the EU Courts.

## Key points of the *Fiat* judgment

- The EC must **only take into account the national law applicable in the member state concerned** when identifying the "normal" taxation system — not any other standard or rule. Doing otherwise would breach member states' autonomy in the field of direct taxation.
- There is **no autonomous arm's length principle in EU law**, irrespective of its incorporation in national law, which the EC would be able to apply as a universal benchmark for tax rulings. The CJEU's 2006 *Forum 187* judgment, which the EC has frequently cited to support its position, relies on the arm's length principle because the relevant member state in that case (Belgium) had incorporated the OECD cost-plus method in its national law.
- Provided that a member state has chosen to apply the arm's length principle in order to establish the transfer prices of integrated companies, the EC must establish that the parameters laid down by national law are **manifestly inconsistent** with the objective of non-discriminatory taxation of all resident companies, whether integrated or not, that should be pursued by the national tax system, by **systematically leading to an undervaluation** of the transfer prices applicable to integrated companies or to certain of them, such as finance companies, as compared to market prices for comparable transactions carried out by non-integrated companies.

[1] Joined Cases C-885/19 P and C-898/19 P *Fiat Chrysler Finance Europe and Ireland v Commission*. *See* also our September 30, 2019, publication, EU General Court Rules on Starbucks and Fiat State Aid Cases.

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## The 2015 EC Decision

The EC found in 2015 that a Luxembourg tax ruling determining the methodology for calculating the taxable profit of Fiat's financing company activities was unlawful state aid. It ordered the Luxembourg government to recover €30 million from Fiat.

The EC viewed the tax ruling as state aid because it allegedly endorsed an artificial methodology for the calculation of taxable profits that "did not reflect economic reality." The EC maintained that in the application of the state aid prohibition in Article 107(1) of the Treaty on the Functioning of the EU (TFEU), intragroup transactions should be remunerated as if they were agreed by independent companies operating under market conditions, in compliance with the arm's length principle. Tax rulings inconsistent with the arm's length principle, according to the EC, confer a selective advantage on integrated companies over stand-alone companies (who transact under market conditions) and may result in illegal state aid under EU law. It did not matter, in the EC's view, whether or how Luxembourg had incorporated the arm's length principle into its national legal system.

Luxembourg and Fiat appealed against that finding to the General Court, which upheld the EC's decision in 2019. Fiat subsequently appealed that judgment to the CJEU (with Ireland as intervener, considering the connection between the case and its challenge of the EC's state aid decision in *Apple*).

## The EC must only consider national law in determining a selective advantage

A finding of state aid requires four conditions to be fulfilled. *First*, there must be an intervention by the state or through state resources. *Second*, the intervention must be liable to affect trade between the member states. *Third*, it must confer a selective advantage on the beneficiary. *Fourth*, it must distort or threaten to distort competition.

The CJEU reaffirmed that the EC could examine tax rulings under the state aid rules.

Such analysis involves a two-step process to determine whether a tax advantage is selective: (1) identifying the "normal" or "reference" tax system applicable in the country concerned, and (2) demonstrating "that the tax measure at issue is a derogation from that reference system" in that it differentiates between operators in a comparable factual and legal situation without justification.

In identifying the reference framework in step (1), the CJEU held only *national* law must be taken into account, not any other standard or rule. This followed from states' sovereignty in tax matters. State aid law does not apply to measures that differentiate between businesses where the member state can demonstrate that such differentiation is justified in light of the objectives pursued by the legal regime pursued. The EC had therefore incorrectly defined the "normal" tax system in Luxembourg as involving non-domestic legal principles.

The CJEU found that the EC had assessed the existence of state aid in this case by referring to the "abstract expression" of the arm's length principle, whereas it should have (respecting Luxembourg's fiscal sovereignty) solely referred to the national tax system and the way in which the national tax system incorporated the arm's length principle. The CJEU concluded that the EC's error vitiated the analysis on selectivity and therefore its decision should be annulled.

## Implications

EC Executive Vice-President and Competition Commissioner Margrethe Vestager called the judgment "a big loss for tax fairness" on Twitter, although she subsequently issued a statement noting that the CJEU "confirmed that action by Member States in areas that are not subject to harmonization by EU law is not excluded from the scope of the Treaty provisions on the monitoring of State aid" and that "the EC is committed to continue using all the tools at its disposal to ensure that fair competition is not distorted in the single market through the grant by member states of illegal tax breaks to multinational companies."[2]

Nonetheless, the judgment is a clear blow to the EC's methodology of seeking to rely on an autonomous EU arm's length principle as a "tool" or "benchmark" to assess whether a tax ruling entails state aid. The judgment provides some welcome degree of legal certainty for companies that any tax planning can be based on national tax laws rather than on abstract concepts introduced by the EC. It is also likely to be a game changer for some of the parallel pending cases before the EC and the EU Courts.

[2] Statement by Executive Vice-President Margrethe Vestager following today's Court judgment on the Fiat tax State aid case in Luxembourg, November 8, 2022.

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