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The McDonald's State Aid Case – The EU Commission Interprets a Tax Treaty

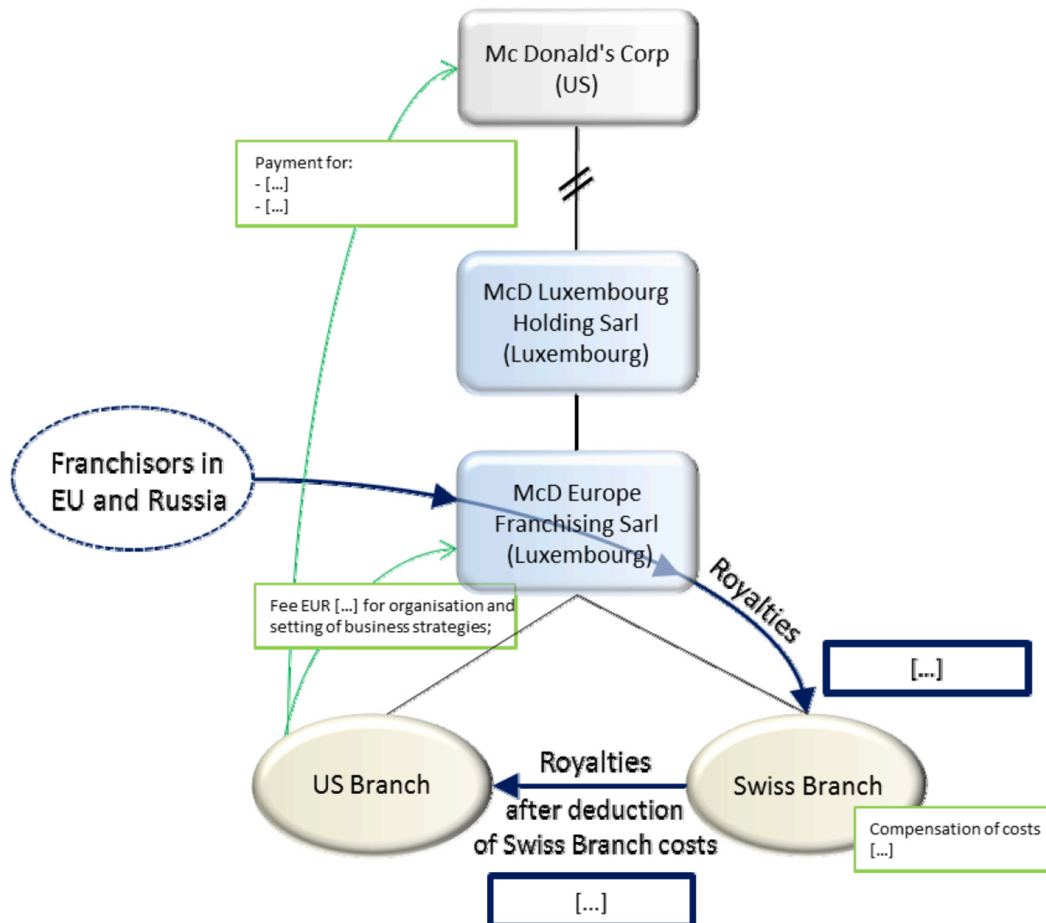
Werner Haslehner (Luxembourg University) · Wednesday, June 22nd, 2016

On 6 June 2016, the European Commission finally released its decision in the McDonald's State Aid case. After the clarifications recently provided on the Commission's position concerning **transfer pricing cases** and the **arm's length principle** (see especially its decision in the Belgian Excess Profits Exemption Scheme, §§ 145–150, clarifying the Commission's reliance on an independent EU-law principle of arm's length based taxation), this decision now provides a clearer insight into the Commission's perspective on cases where the primary issue appears to be double non-taxation (I have previously dealt with both types of cases here). In today's blog post, I will comment on the reasoning applied by the Commission in its McDonald's decision.

As a preliminary remark, it is worth acknowledging that the Commission is **not arguing that double non-taxation per se violates state aid rules** – something that had not been as clear from the original press release on its decision to open a formal investigation published in December last year, quoting Commissioner Vestager as saying *"The purpose of Double Taxation treaties between countries is to avoid double taxation – not to justify double non-taxation"*. However, the Commission's argument effectively results in **imposing on Member States an interpretation of a tax treaty that prevents double non-taxation**. The difference might appear small, but is of course exactly what proper application of the law requires.

The McDonald's case: Facts

As a quick reminder of the facts, the following graphic (taken from the published Commission decision) should illustrate the case:



The main element of the structure at issue is that royalties received by the Luxembourg company are allocated to its US Branch under Luxembourg's interpretation of the LU-US DTC. At the same time, the US did not tax these royalties, considering them not to be "effectively connected with a US trade or business", a condition for taxability of non-resident taxpayers' income in accordance with § 871(b) US IRC. In light of this non-taxation in the US, the Commission thinks the granting of exemption in Luxembourg to be based on an incorrect interpretation of its treaty with the US, claiming that the correct interpretation of Article 23 of that treaty would allow Luxembourg to tax income it allocates to a US permanent establishment if the US does not exercise its taxing right. I will return to this highly doubtful position below, but first it is worthwhile understanding why such erroneous interpretation of its tax treaty would amount to state aid.

Why "voluntary" exemption could be state aid

As noted above, the Commission does not rely on any international principle of single taxation to denounce a double non-taxation result as achieved by McDonald's. Instead, its reference system is Luxembourg's own corporate tax law (see § 69 – referring to *Paint Graphos* as a source to determine that system's objective: somewhat surprisingly, considering that that case concerned Italy and not Luxembourg), which has as a **general principle world-wide taxation of resident companies**, unless a tax treaty provides otherwise. Consequently, refraining from such world-wide taxation without it being mandated by a tax treaty creates an advantage in light of that general principle. The Commission then relies on the Court's judgment in the *MOL* case to refrain from a more detailed selectivity analysis: according to its reading of that judgment, such analysis is

unnecessary whenever an advantage is granted by way of an individual decision. (I consider this interpretation of the Court's judgment and its application to the case of an individual ruling questionable, but will have to reserve that discussion for another time).

The concrete circumstances of the granting of the exemption – Luxembourg had first issued a ruling granting the exemption under the condition that the US would tax the income, which was then replaced by a second ruling without such requirement – seemingly help the Commission's argument, but should be irrelevant: if the tax treaty in its correct interpretation indeed does not require taxation in the US (see next paragraph), **the first ruling was plainly wrong** and therefore ***had* to be replaced**. The undesirability of the outcome from a policy perspective cannot be relevant in this legal assessment.

On the Commission's assessment of the LU-US DTC

At the heart of the matter thus lies the correct interpretation of the LU-US DTC, notably Art. 5, Art. 7 and Art. 25/2 (= Art. 23A OECD MC). Interestingly, the **Commission does not address Art. 5 at all**, which defines a PE for treaty purposes, although it acknowledges that the US's right to tax depends on the existence of a PE (§87). It focuses, rather, on the interpretation of Art. 25/2 and its requirement that the relevant income "may be taxed". The Commission **acknowledges that no actual taxation is required**, but merely a right to tax for the US. It subsequently concludes that *"the profits … cannot be taxed in the United States … [s]ince the US Franchise Branch does not constitute a permanent establishment for US tax purposes"* (§89). It is unclear how it came to that conclusion without an analysis of Art. 5 DTC. It seems likely based on McDonald's tax advisor's explanation that no PE existed for "US tax purposes" (§78). That would seem to be a reference to US domestic law rather than to the DTC. Merely because there is not PE for "US tax purposes" does not mean that the US would consider no PE to exist for purposes of the LU-US DTC. This would remain true even if McDonald's argued differently before the US authorities: in §55, the Commission refers to its US tax return claiming the absence of any PEs for DTC purposes.

To support its conclusion, the Commission also points to the OECD Commentary on Art. 23A, which addresses possible cases of double non-taxation. Before looking further into the Commission's own interpretation of the DTC, a few observations concerning the use of the OECD Commentary:

- First, the LU-US DTC explicitly only refers to the avoidance of double taxation and prevention of tax evasion, but not to the avoidance of double non-taxation
- Second, the LU-US DTC has been concluded in 1996, years before a change of the OECD Commentary that lead to the first inclusion of the cited paragraph
- Third, according to case law of the Supreme Administrative Court of Luxembourg, substantive changes to OECD Commentary cannot affect the interpretation of pre-existing tax treaties (in contrast to "clarifications")
- Fourth, the Commission's result, appears to be based on a **misunderstanding of the OECD Commentary**: The rule cited by the Commission, para. 32.6[1], addresses **conflicts of interpretation**. It allows the residence state to tax income if the source state *"considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax"*. But it seems that **the US** did not consider itself precluded from taxing the income of the US Franchise Branch by the LU-US DTC; it simply **chose not to exercise its taxing right** (see §46 and §54, the latter of which appears to explicitly acknowledge that the US actually had a taxing right under the tax treaty: *"whether the US actually exercises its*

taxing right under the DTT, is therefore irrelevant”).

Did the Commission get it right?

Following the Commission’s argument outlined above, the **key question to be answered remains whether the US had a right to tax the royalties attributed to the US Franchise Branch under the DTC**. The Commission’s assessment is ambiguous on that question: it cannot answer it without analysing whether a permanent establishment existed under Art. 5 as interpreted by the US and whether the income could be allocated under Art. 7 as interpreted by the US.

Despite the criticism above, it is not impossible that the Commission got the correct result: If the US interprets “income attributable to the permanent establishment” (the DTC term) in the same way as “effectively connected with trade or business” (the US IRC term), it may consider itself barred from taxing the royalties in question. One could also argue, however, that in this case the DTC does not really limit its taxing rights, as it would not be blocked from taxing if it changed its domestic law in such a way that it wanted to tax foreign income.

The Commission might have considered more detailed information about US tax law than is visible in the decision: §§52-53, which are heavily redacted, hint at information stemming from McDonald’s US tax returns. The decision makes it also possible, however, that the Commission was somewhat confused about the difference between a PE under domestic law and a PE under the DTC. Merely because there is no PE for “US tax purposes” does not mean that the US would consider no PE to exist for purposes of the LU-US DTC.

Conclusion

The case requires an intricate analysis of a tax treaty. It is questionable whether the Commission got this right. The Commission’s decision is only to open a formal investigation, so more complete enquiry will surely follow. This post aims to point to certain elements that will have to be looked at in more detail before a final decision.

[1] *“The phrase ‘in accordance with the provisions of this Convention, may be taxed’ must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the Source State considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source.”*

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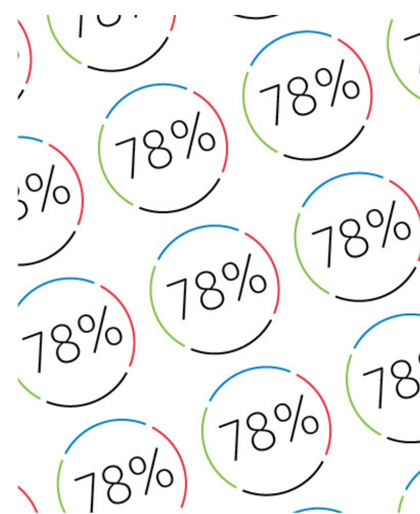

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